NEWSQUARTERLY

WINTER 2005
Volume **24** *Number* **2**

SECTION OF TAXATION

MAY MEETING

Washington

MAY 19-21, 2005 • GRAND HYATT • WASHINGTON, DC

PRIVILEGE PRIMER: AFTER THE TAX SHELTER ASSAULT

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NEWSQUARTERLY
ABA SECTION OF TAXATION

WINTER 2005 VOLUME 24 NUMBER 2

ISSN 1548–8977

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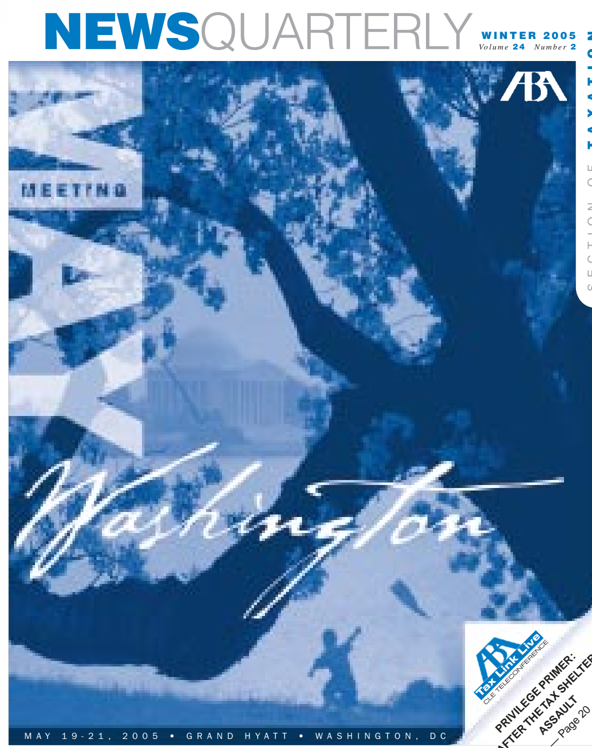

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FROM THE CHAIR

by Kenneth W. Gideon, Washington, DC

KENNETH W. GIDEON

CIRCULAR 230

The long awaited Circular 230 regulations were issued December 17, 2004, and will become effective in June 2005. Given the importance of these regulations to our members, they were the focus of a number of programs at our January meeting, including an address by Cono Namorato, Director of the IRS Office of Professional Responsibility, Saturday, January 22, 2005, as well as the subject of a live teleconference on February 9, 2005, featuring Eric Solomon, Deputy Assistant Secretary for Regulatory Affairs and Acting Deputy Assistant Secretary for Tax Policy at Treasury, Donald Korb, Chief Counsel at IRS, and Ron Wiener, Wolf, Block, Schorr & Solis-Cohen, LLP, Philadelphia, PA. The Tax Section has filed extensive comments on the rules in proposed form, which are available on the Section's website at www.abanet.org/tax/pubpolicy.

Covered opinions and prominent disclosure. The new rules in section 10.35(b)(2) provide that "covered opinions" must comply with four basic requirements: (1) the facts must be identified and ascertained and unreasonable factual assumptions or representations must be avoided, (2) the opinion must relate the law to the facts, (3) the opinion must consider all significant tax issues and reach a "more likely than not" conclusion as to each such issue, and (4) must reach an overall conclusion as to whether the Federal tax treatment of the transaction is the proper treatment. There are, however, significant exceptions from "covered opinions" where the practitioner "prominently discloses" that the advice was not intended or written by the practitioner to be used and cannot be used by the taxpayer for the purpose of avoiding penalties that may be imposed on the taxpayer. *See* section 10.35(b)(4) concerning "reliance opinions," section 10.35(b)(5)(ii) concerning "marketed opinions," and section 10.35(c)(3)(v) concerning "limited scope opinions."

New section 10.37. There are, however, significant limitations on the scope of the "prominent disclosure" exceptions: advice on transactions described in section 10.35(b)(2)(i)(A) and (B) (listed transactions and transactions with "the principal purpose" of tax avoidance or evasion), no matter how informal, cannot utilize the "prominent disclosure" exception. In addition, new section 10.37 provides that a practitioner must not give written advice (including electronic communications) concerning any Federal tax issue that "unreasonably" relies on factual or legal assumptions or on unreasonable assumptions, representations or statements or fails to consider "all relevant facts that the practitioner knows or should know." The January meeting provided a timely forum for discussion of how sections 10.35 and 10.37 are expected to interact and to be applied in practice.

Other changes. A new rule, section 10.39, has been proposed for tax exempt bond opinions. Section 10.38 (concerning the advisory committee) has been modified to clarify that the committee may not make recommendations about actual practitioner cases or have access to information pertaining to actual cases.

JOINT FALL CLE MEETING

Our Joint Fall CLE Meeting with the Real Property, Probate and Trust Law Section in Boston was a resounding success, as more than 1200 registrants attended. More than 600 heard IRS Chief Counsel Donald Korb address our Friday breakfast session on IRS initiatives with respect to exempt organizations and tax shelters. We now plan to hold breakfast sessions with government speakers at the May meeting in Washington and the September meeting in San Francisco.

SECTION WEBSITE/ TECHNOLOGY COMMITTEE

During the Fall Meeting, the Council considered a report on improving our Section website by Vice Chair (Communications) Celia Roady. Work on website improvements is underway, but all suggestions and ideas are welcome and should be forwarded to Celia. To further our website improvement efforts and to facilitate effective use of technology generally by our Section, the Council approved the establishment of a new Technology Committee for the Section, to be headed by Tom Jorgensen. Each Section committee has been requested to appoint a representative to Tom's committee to assist the committees in maintaining and improving committee webpages. The first meeting of the new Technology Committee will be held on Saturday, January 22, 2005, in San Diego and we hope that all committees will be represented at that meeting.

MEETINGS WITH THE GOVERNMENT

In October, Section representatives met with Commissioner Mark Everson

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POINTS TO **REMEMBER**

EDITOR'S NOTE: The three **POINTS** in this issue discuss recent judicial and legislative developments and explore the use of non-traditional investments in retirement plans. In the first Point Glen Mincey and Matt Belcher analyze the implications of recent tax shelter litigation in which taxpayers have prevailed. Mike Steinsaltz then explains the operation of recently enacted section 965, which is designed to encourage repatriation of foreign earnings. Finally, Alexander Drapatsky suggests that individuals consider using retirement plan accounts to hold real estate, businesses, and other assets not usually associated with such accounts.

RECENT CASES ADDRESS SHAM TRANSACTION DOCTRINE

by Glenn Mincey, New York, NY, and Matt Belcher, Washington, DC

While much has been said regarding the IRS's successful tax shelter litigation in *Long Term Capital Holdings v. United States*,[1] a number of cases have recently been decided in which the IRS has been unsuccessful: *TIFD III-E Inc., v. United States*[2] ("*Castle Harbour*"), *Black & Decker Corporation v. United States*,[3] and *Coltec Industries, Inc. v. United States*.[4] It of course remains to be seen exactly what impact these decisions will have, as well as whether the decisions will be affirmed on appeal.

LONG TERM CAPITAL HOLDINGS

Long Term Capital Holdings involved the importation of high basis, low value preferred stock that a foreign bank contributed to a partnership in exchange for a partnership interest. The foreign bank simultaneously acquired a "put right" that entitled the bank to sell its partnership interest to another partner. The bank later exercised its put right and sold its partnership interest at a time when the partnership did not have a section 754 election in effect. Thus, when the partnership later sold the high basis, low value preferred stock, the acquirer of the bank's partnership interest was able to utilize the loss inherent in the property.

The IRS argued that the transaction in *Long Term Capital Holdings* lacked economic substance.[5] The U.S. Supreme Court first applied the economic substance doctrine in the context of disregarding a corporate entity,[6] and the doctrine has since been equally applicable in the context of disregarding transactions that lack economic substance.[7] In holding that a separate entity or a purported transaction may only be disregarded where it is a sham or unreal, the Court established the now landmark two-part test for determining such "sham" status: the first prong—a subjective standard—requiring the taxpayer to demonstrate a legitimate, non-tax business purpose for the formation of the entity under scrutiny; and the second prong—an objective standard—merely requiring a demonstration that the entity has engaged in sufficient business activity to warrant its recognition as a reality.

This standard has been universally applied by courts in matters involving separate entity recognition where corporations are involved.[8] The test for economic substance has also been applied by courts in determining whether partnerships should be respected as entities.[9] While it appears clear that satisfaction of either prong of the test will result in the recognition of a purported transaction or the separate existence of an entity, regardless of whether the other prong is satisfied, these recent cases arguably hold that the two-prong test for economic substance is conjunctive, rather than disjunctive.[10]

The court found that the taxpayers in *Long Term Capital Holdings* had no business purpose in engaging in the transactions at issue other than tax avoidance and that the transaction had no economic substance beyond the creation of tax benefits. Significantly, taking into account transaction costs, the court determined that there was no pre-tax profit potential in the acquisition of the preferred stock. In addition, although the taxpayers averred

1 330 F. Supp. 2d 122 (D. Conn. 2004).

2 342 F. Supp. 2d 94 (D. Conn. 2004).

3 340 F. Supp. 2d 621 (D. Md. 2004).

4 62 Fed. Cl. 716 (Cl. Ct. 2004).

5 The IRS also argued that the transactions should be recast under the step transaction doctrine. The court applied the "end result" test to recast the transactions as a direct sale of the preferred stock by the bank to the partner that purportedly purchased the bank's partnership interest. It appears that the aggressive nature of the transactions may have encouraged the court to apply the most liberal version of the step transaction doctrine even though the recast required the creation of steps that did not actually occur (the contribution by the purchasing partner of the preferred stock to the partnership).

6 Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943).

7 *See* Frank Lyon Co. v. U.S., 435 U.S. 561 (1978); Rice's Toyota World v. Commissioner, 752 F.2d 89 (4th Cir. 1985).

8 *See, e.g.*, Bollinger v. Commissioner, 485 U.S. 340 (1988); National Carbide v. Commissioner, 336 U.S. 422 (1949); Strick Corp. v. United States, 714 F.2d 1194 (3d Cir. 1983); Britt v. United States, 431 F.2d 227 (5th Cir. 1970); Lowndes v. United States, 384 F.2d 635 (4th Cir. 1967); Kimbrell v. Commissioner, 371 F.2d 897 (5th Cir. 1967); Chelsea Products v. Commissioner, 197 F.2d 620 (3d Cir. 1952); Paymer v. Commissioner, 150 F.2d 334 (2d Cir. 1945); Ross v. Commissioner, 129 F.2d 310 (5th Cir. 1942).

9 *See, e.g.*, Campbell County State Bank v. Commissioner, 37 T.C. 430 (1961), *rev'd on other grounds*, 311 F.2d 374 (8th Cir. 1963); Friedlander Corp. v. Commissioner, 216 F.2d 757 (5th Cir. 1954); Cooper v. Commissioner, 61 T.C. 599 (1974); Buffalo Meter Co. v. Commissioner, 10 T.C. 83 (1948), acq. 1948-1 C.B. 1 (1948); Seminole Flavor Co. v. Commissioner, 4 T.C. 1215 (1945).

10 ASA Investerings Partnership v. Commissioner, 201 F.3d 505 (D.C. Cir. 2000); Boca Investerings Partnership v. United States, 314 F.3d 625 (D.C. Cir. 2003); Saba Partnership v. Commissioner, 273 F.3d 1135 (D.C. Cir. 2001); ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998).

that part of the motivation of the transaction was to establish and advance a relationship with the investing bank, the bank's investment in the partnership was intended to be sold to other partners in as short a time as possible and none of the principals in the partnership knew any of the bank owners or officers. Thus, because the court found that the taxpayers in *Long Term Capital Holdings* had failed both prongs of the economic substance test, the court determined that the transactions lacked economic substance and should be disregarded for federal tax purposes.

CASTLE HARBOUR

In *Castle Harbour*, a number of subsidiaries of General Electric Capital Corporation ("GECC") leased commercial aircraft to airlines. To reduce the risk involved in holding aging aircraft in the aircraft leasing business (and, apparently, to replace debt on GECC's balance sheet with minority interest equity), the GECC subsidiaries sought to form a partnership to raise capital from investors. To that end, the GECC subsidiaries contributed the leased aircraft to a partnership with two Dutch banks. The GECC subsidiaries received an 82% interest in the partnership, and the Dutch banks received an 18% interest in the partnership. Under the allocations of the partnership agreement, the banks were allocated virtually all (98%) of the operating income and were subject to minimal risk of loss. In addition, the Dutch banks were allocated a relatively modest share of any appreciation in the assets of the partnership (up to $3 million plus 1% of any gains in excess of $3 million). Finally, although allocated only 2% of the operating income of the partnership, the GECC subsidiaries received an annual guaranteed payment under section 707(c) that equaled, in effect, approximately one half of the annual net income of the partnership.

The GECC subsidiaries had fully depreciated the leased aircraft prior to contributing the aircraft to the partnership. Under application of the partnership rules then in effect (specifically, section 704(c)(1)(A)), the GECC subsidiaries did not have to take into account the difference between the fair market value and the tax basis of the contributed aircraft. Thus, although depreciation was taken into account in determining the section 704(b) book income of the partnership, no tax depreciation was deducted in determining taxable income. Because the Dutch banks were allocated 98% of the net book income of the partnership, the Dutch banks were allocated a corresponding 98% of the taxable income of the partnership; however, because there was no tax depreciation in the partnership, the Dutch banks were not allocated, and could not deduct, any tax depreciation. Thus, the transaction resulted in the allocation of a substantial amount of taxable income from the aircraft leases to the Dutch banks.

The IRS argued that (i) the formation of the partnership in *Castle Harbour* did not have economic substance; (ii) the Dutch banks were not partners, but rather were lenders to the partnership; and (iii) the partnership allocations did not have substantial economic effect. The IRS's argument that the formation of the partnership was a sham should be noted in light of recent decisions in which the D.C. Circuit concluded that, even if the taxpayer in question had a legitimate non-tax business purpose for engaging in a particular transaction, the formation of each partnership served no non-tax purpose.[11] The Connecticut District Court noted that there may be a question in the courts as to whether the test for economic substance required a satisfaction of either prong of the test or both prongs of the test. Nevertheless, because the court determined that the formation of the partnership had both economic effect and business purpose, it did not answer the question.

First, the court found that the contribution by the Dutch banks of $117 million for use by the partnership had real non-tax economic effect. The Dutch banks received a substantial share of the partnership's income in exchange for their investment, and the partnership utilized the funds in its operations to purchase aircraft or to retire liabilities. In addition, the court found that the GECC subsidiaries had a valid business purpose in the need to raise capital and, more importantly, to demonstrate financial viability to their investors despite their fleet of aging aircraft. Thus, the court held that the formation of the partnership had economic substance and was not a sham.

The IRS's argument that the Dutch banks were not partners is also significant in light of the D.C. Circuit decisions mentioned above. In ASA Investerings, foreign investors in a partnership had invested in such a manner that they were in substance never partners but rather lenders to the partnership. The IRS argued that, because the Dutch banks had guaranteed their return from the partnership with minimal risk of loss, and the partnership allocations provided the Dutch banks with only a modest share in partnership asset appreciation, the banks should be considered lenders as were the partners in ASA Investerings. Although the Dutch banks had indeed invested in such a manner that they would receive a minimum return, the banks' return was subject directly to the performance of the aircraft leasing business. Thus, the court held that the Dutch banks should be respected as partners in the partnership.

Finally, the IRS argued that the partnership allocations in *Castle Harbour* did not have substantial economic effect. Even though the GECC subsidiaries owned 82% and the Dutch banks owned 18% of the interests of the partnership, the practical effect of the allocations resulted in virtually all of the net income being allocated to the Dutch investors. The IRS argued that the allocations should have been made in accordance with the partners' investment in capital of the partnership. In addition, although it is not entirely clear from the court opinion, it seems that the IRS argued that the guaranteed payment paid to the

11 *ASA Investerings Partnership*, supra, n. 10; *Boca Investerings Partnership*, supra, n. 10.

GECC subsidiaries should have been treated as an allocation of income. The court stated that investment in capital is only a factor in determining the partners' interests in the partnership, and found that the economic reality of the allocations resulted in the "unambiguous assignment" of 98% interest of the operating income of the partnership to the Dutch banks.[12] Thus, the court found that the allocations of income had substantial economic effect.

COLTEC AND BLACK & DECKER

Coltec and *Black & Decker* involved transactions in which the taxpayers sought to isolate contingent liabilities (asbestos litigation claims in *Coltec* and employee healthcare claims in *Black & Decker*) from other company assets. In each case, the taxpayer contributed assets to a corporation subject to the contingent liability. While the contingent liability reduced the fair market value of the stock received by the taxpayers, such contingent liability was not treated as a liability for purposes of sections 357 or 358. Thus, the liability would not reduce the basis of the stock received by the taxpayers. In each case, each taxpayer later sold the high basis, low value stock for a substantial capital loss and utilized such loss to offset capital gains.

The IRS argued that the transactions in *Coltec* and *Black & Decker* did not have economic substance. Unlike the Connecticut District Court in *Castle Harbour*, which did not address the issue of whether the legal sham test is a disjunctive or a conjunctive test, the Maryland District Court in *Black & Decker*, and the Court of Federal Claims in *Coltec* did address this question. Both the Maryland district court and the Court of Federal Claims analyzed each respective transaction under the disjunctive test. In *Black & Decker*, the court noted that, although the taxpayer conceded for purposes of summary judgment that tax avoidance was its sole motivation for structuring the transaction as it did, the corporation engaged in bona fide economically-based business transactions and therefore had economic substance. Quoting *Rice's Toyota World*, the court stated that it could not ignore a transaction that had economic substance, even if the motive for the transaction was to avoid taxes.[13] In *Coltec*, in finding that the taxpayer had satisfied both the business purpose and economic effect prongs, the court stated that the economic substance doctrine is satisfied upon the satisfaction of "at least" one prong of the two-prong test.[14] Notably, in both *Coltec* and *Castle Harbour*, the courts indicated that Congress, rather than the judicial branch, had the responsibility for establishing the law on what constitutes economic substance.

CONCLUSION

As mentioned above, it remains to be seen exactly what impact these decisions will have, as well as whether the decisions will be affirmed on appeal. However these cases are ultimately resolved, the guidance that such resolution will provide will be eagerly anticipated by tax practitioners.

A **TAX HOLIDAY** FOR REPATRIATED FOREIGN EARNINGS: NEW SECTION 965

by Michael E. Steinsaltz, Philadelphia, PA

INTRODUCTION

On October 22, 2004, the President signed the American Jobs Creation Act of 2004 ("Act"), which contains the most comprehensive international tax reform since the Tax Reform Act of 1986. This Point discusses one of the most important and highly anticipated provisions of the Act: new section 965, which, for a limited time, provides very favorable tax treatment for repatriated foreign earnings.

Section 965 allows for a one-year 85 % dividends received deduction ("DRD") for certain cash dividends received by U.S. shareholders from controlled foreign corporations ("CFCs"). The deduction will make it possible for many taxpayers to repatriate foreign earnings at a much lower tax cost than would be possible under current law. If several technical issues with the Act are resolved favorably for taxpayers, effective tax rate on dividend distributions under section 965 will be 5.25%.[1]

Not surprisingly, some limitations apply. The DRD is limited to the excess of all current year dividends from CFCs over a base period amount ("extraordinary dividend limitation") and is capped at the greater of $500 million or the amount of permanently reinvested earnings shown on the taxpayer's most recent financial statements certified on or before June 30, 2003. The new provision also restricts how such dividends can be financed ("related party indebtedness rule") and how the cash received by U.S. shareholders must be used ("domestic reinvestment plan"). It also disallows foreign tax credits and allocable expenses to the extent that they relate to the deductible portion of the dividends. The effective date is, at the taxpayer's election, either the last taxable year that begins before the date of enactment, or the first taxable year that begins during the one-year period beginning on the date of enactment.

Because the new provision can be so beneficial to so many taxpayers and because it is of limited duration, it is important to begin planning immediately. Optimizing the planning opportunities under section 965 requires an examination of some of the questions raised by the provision. This Point will identify those questions and discuss likely appropriate responses.

12 *Castle Harbour*, supra, n. 2, at 80.

13 *Black & Decker*, supra, n. 3 at 7.

14 *Coltec Industries*, supra, n. 4 at 128.

1 On Friday, November 19, 2004, a Technical Corrections Bill (the "Bill") was introduced into the House of Representatives. The Bill addresses several key issues identified in this Point. As of the date of publication, the technical corrections contained in the Bill have not been enacted into law. Nevertheless, where relevant, the impact of the Bill is noted.

CASH DIVIDEND

Although the section 965(a)(1) DRD is only available for "cash dividends," section 965 does not affirmatively define the term "dividend". Nevertheless, section 965(c)(3) provides that the term "dividend" shall not include amounts includible in gross income as dividends under sections 78, 367, or 1248, and the Conference Committee Report ("Conference Report") explains that the deduction applies "only to cash dividends and other cash amounts included in gross income as dividends, such as cash amounts treated as dividends under sections 302 or 304 (but not amounts treated as dividends under sections 78, 367, or 1248)." Although sometimes thought of as deemed dividends, amounts included in a taxpayer's gross income under subpart F and section 956 are not technically dividends under Section 316. Thus, subpart F and section 956 inclusions are not generally eligible for benefits under section 965.

Section 965(a)(2) expands the definition of a cash dividend to include certain election year cash distributions that are excluded from gross income as previously taxed income ("PTI") under section 959(a). The PTI exception applies to the extent that the subpart F income that created the PTI results from the payment of a dividend by one CFC to another CFC (i.e., a dividend treated as foreign personal holding company income under section 954(c)(1)(A)) with the result that the cash travels through a chain of CFCs to the taxpayer within the election period. This provision allows dividends to be paid through multiple tiers of CFCs.

On January 10, 2005, the Treasury Department and the Service issued Notice 2005-10 ("Notice") providing guidance on new section 965. The Notice addresses the meaning of the term "cash dividends." It provides rules regarding the treatment of foreign currency and cash equivalents as cash, and how to treat cash dividends received by pass-through entities such as disregarded entities and partnerships. The Notice also addresses whether the amount of a cash dividend is reduced by expenses or deductions of the taxpayer related to such cash dividend, including foreign withholding tax and U.S. federal, state or local income tax imposed thereon.

EXTRAORDINARY DIVIDEND LIMITATION

Section 965(b)(2) limits the amount of dividends that can be taken into account under section 965(a) to the excess of:

(a) Dividends[2] received during the taxable year by shareholders from CFCs; over

(b) The annual average for the base period years of dividends, section 956 inclusions, and distributions of PTI (other than distributions attributable to prior taxable year section 956 inclusions) (collectively referred to as "annual amounts").

The average of the annual amounts is referred to as the "base period amount." Base period years are comprised of the five taxable years ending on or before June 30, 2003 disregarding the taxable years with the highest and lowest annual amounts. The annual amounts are determined based on amounts shown on the most recent return filed for each base period year, except that amended returns filed after June 30, 2003 are not taken into account.

If a taxpayer has fewer than five taxable years ending on or before June 30, 2003, then the base period includes all taxable years of the taxpayer ending on or before June 30, 2003. The average annual amount is adjusted for certain mergers, acquisitions, spin-offs and other dispositions.

RELATED PARTY INDEBTEDNESS

The related party indebtedness rule of section 965(b)(3) may prove to be one of the most challenging elements of section 965. Section 965(b)(3) provides that the amount of dividends eligible for the DRD must be reduced by the increase in related party indebtedness of the taxpayer's CFC from October 3, 2004, until the close of the tax year for which the taxpayer elects to apply section 965. For purposes of this limitation, the taxpayer must treat all CFCs for which it is a U.S. shareholder as a single CFC. According to the Conference Report, this rule is intended to prevent a taxpayer from claiming the DRD in cases in which the taxpayer itself directly or indirectly finances the payment of a dividend from a CFC. In such a case, the Conference Report states, "there may be no net repatriation of funds, and thus it would be inappropriate to provide the deduction."

The related party indebtedness rule prohibits a taxpayer or non-CFC related party from lending funds to one or more CFCs to finance a distribution of earnings. This restriction is relevant where the distributing CFC does not have cash on hand to pay the dividend. It also prohibits a CFC from distributing a note to the taxpayer rather than cash. Perhaps most importantly, the related party indebtedness rule may be a trap for taxpayers that increase lending to one or more CFCs for purposes other than to finance a dividend distribution. For example, the rule appears to apply to a loan from a taxpayer to a CFC to finance an acquisition by the CFC or to satisfy increased working capital requirements of the CFC. The related party indebtedness rule does not prohibit lending from one CFC to another to finance a distribution from such CFC because all CFCs are treated as a single CFC under the rule.

The reference to "net repatriation of funds" in the Conference Report raises the specter that transactions not covered by the literal language of section 965(b)(3) but do not in substance amount to a net repatriation of funds to the U.S. could also be challenged by the Service.[3] For example, this language

2 The Bill adds the word "cash" before the word "dividends." Thus, if enacted, the Bill would deny a taxpayer the ability to satisfy the base period amount with non-cash dividends.

3 The Bill provides the Secretary with regulatory authority as may be necessary to prevent the avoidance of the related party indebtedness rule, including authority to promulgate regulations which provide that "cash dividends" would not be taken into account under section 965(a) "to the extent such dividends are attributable to the direct or indirect transfer (including through the use of intervening entities or capital contributions) of cash or other property from a related person to a CFC."

could bolster a challenge by the Service under existing circular cash flow, substance over form, and sham transaction principles. Despite this language, third party borrowing (including borrowing guaranteed by the taxpayer) to finance DRD eligible dividends under section 965 appears to be permitted so long as the CFC that purports to be the borrower is treated as such under general U.S. tax principles (see e.g., Plantation Patterns v. Commissioner, 462 F.2d 712 (5th Cir.), cert denied 409 U.S. 1076 (1972)). Thus, taxpayers that need to finance dividends to obtain maximum benefit under section 965 should carefully plan how such financing will be structured.

DOMESTIC REINVESTMENT

The section 965 DRD only applies to dividends invested in the U.S. pursuant to a domestic reinvestment plan. Such a plan must be approved by the taxpayer's president, CEO, or comparable officer before the dividend is paid and must subsequently be approved by the taxpayer's board of directors, management committee, executive committee, or similar body. The plan must provide for the reinvestment of the dividends in the U.S. Although the dividends cannot be used for the payment of executive compensation, they may be used as a source for the funding of worker hiring and training, infrastructure, research and development, capital investments, or the financial stabilization of the corporation for the purposes of job retention or creation. This list of permissible uses for the dividends is not exclusive. The Chairman's Mark indicated that concept of reinvestment in the U.S. should be construed broadly, but the final Conference Report dropped that language without explanation. The domestic reinvestment plan need not apply to dividends for which the DRD is not being claimed.

In addition to grappling with the related party indebtedness rule, taxpayers will likely find it challenging to ensure that they have satisfied the requirements of a valid domestic reinvestment. The description of eligible uses for the dividends is open to significant interpretation. Questions include: how will a taxpayer demonstrate that the dividend was used to hire or train workers, build infrastructure, conduct research, etc? Must the activities undertaken pursuant to the plan be incremental? How expansive is the "financial stabilization" language? If the list of cash uses is not exclusive, what other forms of reinvestment will qualify and how will taxpayers document such uses?

The Notice provides answers to many of these important questions. It provides general guidance concerning domestic reinvestment plans, lists certain expenditures that, if made pursuant to a domestic reinvestment plan, are investments in the U.S., and lists certain expenditures that are not permitted investments. The Notice also provides guidance on reporting requirements and on how a taxpayer may, under the facts and circumstances, establish to the satisfaction of the Commissioner that the dividend proceeds are invested in the U.S. pursuant to a domestic reinvestment plan, including a safe harbor for making such a demonstration.

CREDIT AND EXPENSE DISALLOWANCE

Section 965(d)(1) provides that no foreign tax credits or deductions for foreign taxes are allowed for any taxes paid or accrued (or treated as paid or accrued) with respect to the deductible portion of any dividend or PTI distribution. Interestingly, section 965 does not provide for the elimination of the section 78 gross-up related to such non-creditable and non-deductible foreign taxes. Under the literal language of section 965, foreign taxes related to deductible dividends appear to be included in gross income without the benefit of an offsetting credit or deduction. Many tax professionals believe that this is an unintended drafting error and hope for a technical correction or for regulatory guidance that would alleviate the negative consequences of this provision by excluding from gross income foreign taxes that are disallowed under section 965(d)(1) or by permitting a deduction for such taxes to offset the section 78 gross-up which they generate.[4]

The disallowance of foreign tax credits related to the deductible portion of any dividend or PTI distribution means that taxpayers will want the flexibility to choose which cash dividends are used to satisfy the base period amount (if any) and which are entitled to a DRD under section 965. This flexibility is important because taxpayers will want to specify that high tax dividends are allocated to the base period amount and low tax dividends are allocated to the section 965(a) amount eligible for the DRD. The Conference Report provides that taxpayers may specifically identify which dividends are treated as carrying the deduction and which are not.

Section 965(d)(2) provides that no deduction shall be allowed for expenses properly allocated and apportioned to the deductible portion of any cash dividend. This language would normally connote broad expense allocation principles such as those contained in section 861 and Treas. Reg. § 1.861-8. However, in each of the House and Senate colloquies, Rep. Thomas and Senator Grassley indicated that their intent was for narrow expense allocation. They each stated that the "intent of the rule is to disallow only deductions for expenses that relate directly to generating the dividend income in question." Senator Grassley further stated that "related expenses would include, but is not limited to, stewardship costs and directly related legal and accounting fees." Despite these statements, the application of the expense disallowance rule remains unclear, at least until the Service issues guidance on the matter.[5]

4 The Bill does provide for the elimination of the section 78 gross-up on taxes that are non-creditable pursuant to section 965.

5 The Bill changes the phrase "properly allocated and apportioned" to "directly allocable." This appears to be a narrowing of the expense disallowance provision of section 965.

CONCLUSION

Section 965 gives taxpayers a unique, one-time opportunity to repatriate earnings from CFCs at a significantly reduced tax cost. Taxpayers should begin now to plan for the many issues that will arise in developing a repatriation plan so that they secure the benefit of section 965 with a manageable level of risk.

BUYING REAL ESTATE THROUGH IRAS AND QUALIFIED PLANS

by Alexander Drapatsky, Chicago, IL

Clients looking for sources of investment capital often overlook the obvious. As the life expectancies and retirement ages of Americans increase, the amount of assets they own through IRAs and qualified plans ("Retirement Plan Assets") have increased as well. Most clients think of mutual funds, equities and debt instruments as appropriate assets to hold in retirement accounts. However, more clients are using "non-traditional" investments, including investments in start-up businesses and investment real estate, as Retirement Plan Assets.

IRA AND PLAN CONTRIBUTION LIMITS

The 2001 Economic Growth and Tax Relief Reconciliation Act increased the maximum amounts individuals may contribute to IRAs and qualified plans. In 2005-07, individuals may contribute up to $4,000 to an IRA per year. This amount will increase to $5,000 in 2008, and will be indexed for inflation thereafter. Participants in employer sponsored qualified plans may contribute and/or receive employer contributions of up to $40,000 per year. Moreover, individuals age 50 or older may contribute to IRAs and employer sponsored plans additional amounts in excess of the basic annual contributions.

The growth in Retirement Plan Assets has also increased because many taxpayers who departed employers that sponsored qualified plans have rolled-over their Retirement Plan Assets into IRAs. Such IRAs, unlike employer-sponsored plans, may be self-directed and assets held in them could also be made available for investment capital.

OPERATION OF SELF-DIRECTED IRAS

A self-directed IRA or retirement plan is one in which the account owner decides on the investments, which are not offered by the IRA custodian. Such self-directed plans contain investment language that permits account owners to direct the trustee or custodian of the plan to make any investment permitted by law. The plan documents must also state that the custodian will not allow transactions that the Code and ERISA prohibit with respect to Retirement Plan Assets.

A retirement plan account that does not violate the prohibited transaction rules discussed below can be used to invest in real estate, including vacant land, commercial buildings, rental properties, promissory notes, tax certificates, and even interests as tenants-in-common. Such accounts could also acquire real estate interests via private equity such as interests in limited partnerships, LLCs, and C corporations. A retirement plan account may hold real estate in conjunction with other owners, provided the deed or other ownership document clearly reflects the portion of the property owned by such account, and that such portion is an undivided interest. However, a disqualified person (discussed below) cannot own any portion of such real estate.

Real estate, as much as any investment asset, is generally subject to leverage. A retirement plan account investing in leveraged real estate may be subject to additional risks, including (1) whether the loan will constitute a prohibited transaction; and (2) whether the investment will expose the account to liability for unrelated business taxable income. Both are discussed immediately below.

PROHIBITED TRANSACTION RULES

Section 408(a) imposes specific requirements on IRAs, which if satisfied, will allow the assets in such accounts to grow tax-deferred. Such requirements include: (1) the IRA trust must be in writing; (2) the contribution limits must be stated in the trust document; (3) the IRA must be created or organized in the United States; (4) the trustee/custodian generally must be a financial institution, unless the trustee can demonstrate to the IRS that it is capable of administering an IRA; (5) the account must be created or established for the exclusive benefit of an individual or his beneficiaries; (6) the IRA agreement must prohibit investment in "life insurance contracts"; (7) the IRA agreement must provide that the assets of the trust or custodial account will not be commingled with other property, except in a common trust fund or common investment fund. Employer sponsored qualified plans must meet these and additional requirements in order to remain "qualified."

Even if a retirement plan account meets the foregoing statutory requirements to allow its assets to grow tax deferred, the Code prohibits certain transactions between an IRA and "disqualified persons." Similar rules apply to qualified plans. Section 4975(e)(2) defines a disqualified person as a fiduciary, plan service provider, plan sponsoring employer, majority equity owner, family member of an account owner, and officer, director or other employee of a business sponsoring such plan. If a prohibited transaction occurs between a disqualified person and a retirement account, excise taxes, income taxes and loss of the account's status as an IRA or qualified plan might result.

While the Code and ERISA do not state permissible retirement plan investments, these statutes do state what is prohibited (subject to numerous exceptions). Specifically, both the

Code and ERISA prohibit the following transactions:

(1) Sale or exchange, or leasing, of any property between a plan and a disqualified person;
(2) Lending of money or extension of credit between a plan and a disqualified person;
(3) Furnishing of goods, services or facilities between a plan and a disqualified person;
(4) Transfer to or use by a disqualified person of any assets or income of a plan;
(5) An act by a fiduciary to use the assets or income of a plan in the fiduciary's own interest (i.e., self-dealing); and
(6) The receipt of consideration by a fiduciary for the fiduciary's own account from any party dealing with a plan (i.e., kickbacks).

Like many Code provisions, the foregoing prohibited transactions are subject to numerous exceptions. Nevertheless, if the Service determines that a prohibited transaction has occurred, it can impose a two-tiered tax on such transaction. Under section 4975, the Code automatically imposes an initial tax of 15% of the amount involved in the transaction on disqualified persons who participate in a prohibited transaction for each year or part of a year dating from the time the transaction occurred until the transaction is corrected or until the tax is assessed. An additional tax equal to 100% of the amount involved falls on the disqualified person if the transaction remains uncorrected within the taxable period ending with the assessment or notice of deficiency with respect to the above initial tax.

Provided a retirement plan account does not transact business with a disqualified person, the opportunities to invest in real estate through such accounts are significant. Retirement plan accounts cannot borrow money from the account owner or relatives of the account owner. Neither can retirement plans accounts acquire real estate in which the IRA and the IRA owner will own an interest. Nor can retirement plan accounts acquire real estate and then allow a disqualified person to use it while it is in the plan. However, if accounts do not participate in prohibited transactions they can acquire, rent, sell, and otherwise deal with real estate and defer tax on the resulting income.

However, in addition to the above possible excise taxes, other taxes could result. Earnings in a retirement plan account are generally exempt from tax. However, certain investments create taxable income called unrelated business taxable income ("UBTI"). UBTI includes retirement plan account income from a trade or business regularly carried on by such account that is not substantially related to its tax-exempt purpose.

Fortunately, many types of income are exempt form UBTI. Dividends, interest, annuities, royalties, and most rents from real property are excluded from UBTI. IRC § 512(b). Gains and losses from the sale of property (other than inventory) are also excluded from UBTI. *Id.* However, for leveraged property (i.e. property acquired through debt financing), the referenced exclusions from UBTI are subject to a significant limitation.

One type of UBTI of particular import to real estate investors is known as "Unrelated Debt-Financed Income." This is income derived from debt-financed property owned by otherwise tax-exempt organizations (such as retirement plan accounts) and not used in furtherance of the organization's exempt purpose. Fortunately, the Code contains an exception to this rule and allows a retirement plan account to acquire and own real estate subject to acquisition indebtedness, and to collect income from such real estate, without such income being classified as Unrelated Debt-Financed Income. IRC § 514(c)(9). To qualify for this exception, the purchase price must be fixed at the time real estate is acquired. Owners of retirement plan accounts seeking to acquire real estate must plan carefully to avoid incurring UBTI.

CONCLUSION

Astute taxpayers may have a wealth of opportunities to invest through retirement plan accounts. Provided a taxpayer does not run afoul of the prohibited transaction rules or cause a retirement plan account to incur UBTI, such taxpayers may be able to access significant investment capital through such accounts. Such taxpayers could also defer paying income tax on rental income, capital gains, and other real estate related income.

Most national brokerage houses do not allow self-directed retirement plan accounts because they do not yet believe this would be profitable. However, a quick internet search reveals that many smaller brokerage houses offer a variety of services related to self-directed retirement plan accounts. Opportunities exist for those willing to think creatively. ■

POINT & COUNTERPOINT:

EXPORT SUBSIDIES: ALWAYS BAD OR SOMETIMES GOOD?

INTRODUCTION: Export subsidies have always been controversial. In 2002, the World Trade Organization found that the extraterritorial income exclusion ("ETI") regime adopted by the United States in 2000 constituted an illegal trade subsidy and authorized members of the European Union to impose penalty tariffs on U.S. exports. Tariffs were eventually imposed and in October, 2004, Congress responded. The American Jobs Creation Act of 2004 repeals ETI over a three-year period but also provides a number of tax benefits to U.S.-based multinational companies. In this Point Counterpoint Professors Michael McIntyre and Terrence Chorvat debate the desirability of tax incentives for exports as a general proposition. Professor McIntyre argues that such incentives are never desirable or appropriate, while Professor Chorvat argues that in some cases, such incentives can serve desirable objectives. Professors McIntyre and Chorvat have each testified on this issue before Congress. Their views help to illuminate a debate that is certain to rage for some time to come. —*Gail L. Richmond*

THE CASE FOR **FREE TRADE**

by Michael J. McIntyre, Detroit, MI

The virtues of free trade have been well known at least since the publication of WEALTH OF NATIONS by Adam Smith in 1776. According to free-trade theory, export subsidies benefit the foreign recipients of the subsidies at the expense of a country's own population and economy. If that theory is correct—and most commentators believe it is—then the recent World Trade Organization (WTO) decision that led to the repeal of a U.S. export subsidy can be viewed as a major victory for the U.S. economy.

Whenever special interests seek to promote export subsidies or import barriers, they assert that the special benefit they receive will result in the creation of additional jobs in the U.S. economy. Whether the preference will create jobs in the favored industry is not always clear. What is clear is that national wealth is reduced by both trade barriers that prevent trade from occurring and by trade subsidies that cause trade to occur that otherwise would not occur. In general, any jobs created from wealth-reducing activities are likely to be more than offset by jobs destroyed by those activities.

As a simplified illustration of the case for free trade, assume that the United States tries to stimulate exports by providing a subsidy of $25 per spool for each spool of copper wire that is exported. CopperCo takes advantage of the subsidy to lower the price of its wire exports by $25 a spool. To meet the increased demand for its exported wire, it hires some additional U.S. employees. So far, the subsidy seems to be working.

A trade subsidy, however, is unlikely to have just one effect. Assume that MotorCo manufactures electric motors in the United States and sells them domestically and abroad. Copper wire is a major component of an electric motor. Although the export subsidy does not change the price MotorCo pays CopperCo for wire, MotorCo's foreign competitors can now buy copper wire at the subsidized price. Their ability to reduce their price for electric motors in both the U.S. and foreign markets creates competitive problems for MotorCo. As a result of the new competition, MotorCo loses domestic and foreign sales of motors and must reduce the number of employees at its U.S. plant. Whatever jobs were gained from the expansion of CopperCo's business might be lost from the contraction of MotorCo's business. In addition, U.S. taxpayers are now paying the bill for the export subsidy.

The basic pattern illustrated above is a familiar one to those who followed the action of the Bush administration in imposing quotas on steel imports—quotas that obviously violated U.S. trade agreements and were rolled back after our trade partners won a suit for redress. During their brief existence, the steel quotas probably increased sales of U.S.-produced steel products, but they also caused an increase in the cost of manufacturing automobiles and other steel-containing products in the United States.

The adverse effects of trade subsidies are magnified many times if other countries respond by erecting barriers to trade or by adopting their own export subsidies. One of the major purposes of the United States in helping to establish the WTO was to keep other countries from making both the U.S. and themselves poorer by violating free-trade principles. Another major purpose was to prevent the almost inevitable disputes over trade practices from escalating out of control. The Truman Administration, which took the leadership role in establishing the basic instruments of free trade after World War II, was reacting in part to the huge decline in world welfare that resulted from the international trade wars of the 1920s and 1930s.

Free trade has come under attack in the United States from some quarters largely because of the perceived impact of outsourcing on good American jobs. There is little doubt that the United States has been losing jobs to overseas producers during the Bush administration. Many U.S. companies that once produced goods domestically have moved production overseas, seeking lower wages, tax loopholes, lax environmental controls, and other financial advantages. These companies then take

advantage of U.S. free-trade agreements to import the foreign-made goods into the U.S. market.

The exporting of U.S. jobs is not a new phenomenon. It has been going on for several decades. Previously, however, the U.S. economy produced new, often better jobs to replace those being exported. During the Clinton years, when the U.S. economy was operating at close to full employment, it was reasonable to assume that a U.S. worker who was displaced by a low-wage foreign worker would just find another job, equally good or better. There were, of course, some legitimate concerns. In particular, some communities that lost a major employer incurred substantial dislocation costs, and some people losing a good job in the manufacturing sector lacked the training needed to take the jobs opening up in the service sector. More fundamentally, income inequality was increasing for a variety of reasons, some related to free-trade policies. Nevertheless, free trade generally made the country richer and opened up more opportunities for U.S. workers.

The creation of new jobs slowed considerably during the Bush administration. With the U.S. economy operating at well below full employment, a displaced worker may end up unemployed or employed at a less desirable job. These displaced and unemployed or under-employed workers have a legitimate complaint. Their complaint, however, is more properly directed at the policies leading to low employment levels, not at free trade.

Various explanations have been offered for the so-called jobless recovery after the recession of 2001. Almost certainly, a major reason for low job creation has been the huge budget deficits, which are being financed in significant part with foreign debt. Those budget deficits, in turn, are the inevitable result of the 2001 and 2003 tax cuts, which heavily favored corporations and well-to-do individuals.

The close link between job losses and foreign borrowing is illustrated by the following example. Assume that U.S. chicken farmers sell $10,000 worth of eggs to pig farmers in Canada, receiving in exchange $10,000 worth of bacon. That trade might reduce jobs for chicken farmers in Canada but might increase jobs for both Canadian pig farmers and U.S. chicken farmers. Since the trade is a wealth-creating transaction, the likelihood is that the new jobs will be as good as or better than the jobs lost. In real life, of course, the trade would be done using some medium of exchange rather than through barter. But so long as the money received by the Canadian bacon sellers ends up being used to buy goods and services produced in the United States, the trade should be beneficial for U.S. job creation and job enhancement.

Of course, the United States does not have the type of balanced trade illustrated in the above example. The United States runs a chronic trade deficit, especially with China and certain other countries in Asia. A significant reason for the trade deficit is the budget deficit. Foreigners selling goods here have two potential uses for the dollars they receive. They can buy U.S. goods and services, resulting in U.S. job creation, or they can buy U.S. assets, such as stock, real property, or Treasury notes. Oversimplifying only slightly, each dollar generated by imports that the foreigner ends up lending (directly or indirectly) to the U.S. government to finance the budget deficit is one less dollar used for buying U.S. goods and services. Thus, the deficit undermines the ability of U.S.-based firms to export goods and to generate good U.S. jobs.

Unfortunately, the budget deficit is increasing rather than decreasing. The repeal of the illegal U.S. export incentive, viewed in isolation, increased U.S. tax revenues. The repeal was part of a much larger tax bill, however, that will greatly increase the deficit, despite disingenuous claims that the legislation is revenue neutral. In addition, the bill contains major changes in the international income tax rules that will increase the already strong tax bias in favor of foreign production over domestic production.

The case for free trade, although robust, is not absolute. No one can argue convincingly, for example, for free trade in U.S. military secrets. In general, a country's trade policies ought to be pursued in the context of other important national policies, such as social justice, a clean and safe environment, and national security. A commitment to free trade certainly is not a commitment to the *laissez faire* economics of the 19th century. On the contrary, free trade is unlikely to benefit the majority of U.S. workers unless it is combined with strong measures to reduce income inequality—an inequality that frequently is exacerbated by free-trade policies.

IN DEFENSE OF THE INDEFENSIBLE: EXPORT SUBSIDIES IN A SECOND-BEST WORLD

by Terrence R. Chorvat, Arlington, VA

I would like to state the case for free trade somewhat differently than the way that Professor McIntyre does. There is general agreement that free trade is economically efficient. The relevant questions are, rather, what constitutes an impediment to free trade, how should we respond to existing impediments to free trade, and how does the tax system intersect with other areas of the law and the economy so as to create and reduce impediments to free trade?

The basic premise behind the efficiency of free trade is that of specialization. Individuals or groups of individuals will be more able to produce certain goods and services efficiently if they specialize in their production, and the talents or other factors that allow for more efficient production are allocated non-uniformly among the world's population. Therefore, we all gain by being able to trade as freely as possible with all producers in the world. In general, interference with free trade will reduce the efficiency of the economy, as Professor McIntyre shows. The conclusion commonly drawn from this analysis is that, to the extent that institutions such as tax systems alter the allocation of productive resources from the allocation of the market, such a reallocation will operate to reduce total welfare. Economists,

going at least as far back as Pigou, have made arguments that to the extent that taxes or other interventions are attempting to mitigate existing market imperfections, then such interventions may improve welfare. However, the general presumption is that, absent some showing to the contrary, interference with the market is bad.

Professor McIntyre gives a good statement of the first-best argument for free trade. However, we do not live in a first-best world. We live in a second- or third- or worse-best world. Countries vary not only by productive resources but also by their institutions. These institutions introduce distinctions that can interfere with efficient production. Once these distortions exist, it is no longer clear that what would be optimal in a first-best world would necessarily be optimal in the world in which we live. I am going to discuss some styled facts about the tax systems that we see in the world, and use these to argue that in fact there may be some justification for an export subsidy operated through the tax system. I will argue that even though export subsides would be inefficient in a first-best world, it is not so apparent that they are inefficient in the world in which we find ourselves. I need to be clear that I am arguing not for any particular system of export subsidies, nor do I maintain that there might not be additional facts that argue against export subsidies; I am merely arguing against the idea that export subsidies are inherently inefficient.

To illustrate the case for export subsidies, imagine a world of three countries (A, B, and C) that have the characteristics described in this paragraph. Countries A and B each have companies that compete against each other in the world-wide market for widgets. Consumers in Country C purchase widgets. Country A raises its revenue from an income tax, which is imposed on the worldwide income of firms resident in A, Country B raises its revenue from a border-adjusted VAT, and Country C, which has a low level of government services, raises its revenue from hotel taxes and casino taxes. Capital is perfectly mobile between A and B. Consumption taxes do not affect the prices charged by firms resident in Countries A and B, or to the extent they do, those taxes are borne equally by firms in both countries.

Because Country A and Country B have different tax systems, a distortion between production by Country A's firms and Country B's firms is introduced. To understand this, we must first note that this is not the same as the distortion that would be introduced by a tariff. A producer in Country A pays tax on income from selling its product in Country C. By contrast, a producer in Country B will effectively pay no tax on its product sales because of the border-adjusted VAT. Initially, one may think that because the Country A firm is subject to an income tax, it must charge a higher price than that charged by the Country B firm. Although it is true that the Country A firm is at a competitive disadvantage, the situation is more complicated than it appears. Just because the Country A firm makes a lower profit on each sale, this does not mean that it will charge a higher price. Because the point at which marginal profit approaches zero (the point at which the profit function is maximized is the point where the derivative of profit with respect to price equals zero) is unaffected by a tax applied against a constant percentage of profit, the Country A firm is not forced to raise its price despite lower profits. The firm has no incentive to shift to a different product, because any alternative use of its capital will also have a lower rate of return (assuming that the tax is uniformly imposed on income from capital in a worldwide tax system such as that imposed by the U.S.). Therefore, it would seem that there is no reason why the Country A firm would not be competitive in the Country C market.

The distortion in this case arises from the fact that because the producer in Country A receives a lower rate of return than its counterpart in Country B, the Country A producer will attract less capital. Therefore assuming that capital will increase the efficiency of labor, and effectively lower the price, or there is some similar increase in efficiency, the producer in Country A is at a disadvantage vis-à-vis the producer in Country B. As a result of the free mobility of capital, more capital will flow to the producer in Country B. So long as capital investments allow one firm to produce more efficiently, the Country B firm will enjoy a competitive advantage.

This argument can be extended to competition in Country B, by applying the Country C analysis to competition within Country B. As long as the Country B VAT applies equally to the products from the Country A firm and the Country B firm, then the Country A firm widgets must again bear both the VAT and the income tax, while the Country B firm widgets bear only the VAT. So there would still be a distinction in the after-tax rates of return on capital invested in the two businesses. The argument would not apply to competition within Country A, if Country A imposes an income tax on the profits that Country B firm made from its sales to Country A consumers; in this situation, firms would pay only the Country A income tax. The distortion would also still arise, although with lesser force if all three countries impose income taxes but rates are lower in Countries B and C than in Country A.

There are many reasons why the effect of the increase in the cost of capital may be difficult to find empirically (as Dixit and Pindick discuss in their highly readable book, Investment Under Uncertainty). Nonetheless, it is clear that even in the absence of other constraints, export subsidies may in fact be making up for other institutional inefficiencies.

It is not my intention to argue that the situation discussed above is or was a justification for the foreign sales corporation or the extraterritorial income regimes. The above argument relies on a number of assumptions, which may or may not reflect the situation at any particular time. This is an empirical question, and it could very well be that the export subsidies that we had in place until recently were inefficient. This does not mean that export subsidies must necessarily

be inefficient, given some of the stylized facts we know about the tax systems of the world. Because this is an empirical question, it must be addressed by empirical evidence, which might also change over time.

Another important point is that even if export subsidies may occasionally be efficient, it might make sense to prohibit them because there is such a large potential for mischief. But one needs to understand that getting rid of export subsidies now adds an additional argument for adopting consumption taxes, which again each of us may or may not prefer. In addition, it is not at all clear that the income tax burden of United States corporations is necessarily higher than that of corporations based in other countries. To the extent that some countries have higher taxes, but the governments of these countries provide additional benefits for businesses operating within their borders, it is not clear that the above analysis applies. ■

CLE CALENDAR

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

DATE	PROGRAM	CONTACT
March 14–18, 2005	**ABA/IPT 14th Annual Advanced Sales/Use Tax & Advanced Property Tax Seminars**, New Orleans, LA	ABA Tax Section www.abanet.org/tax 202-662-8670
March 30, 2005	**"Last Wednesday" Teleconference Series: Buy-Sell Agreements for LLCs and S Corporations**	ABA Tax Section www.abanet.org/tax 202-662-8670
April 7–8, 2005	**ABA/IBA 5th Annual Tax Planning Strategies in U.S. and Europe**	ABA Tax Section www.abanet.org/tax 202-662-8670
April 13, 2005	**"Tax Link Live" Teleconference: Attorney-Client and Work Product Privileges**	ABA Tax Section www.abanet.org/tax 202-662-8670
April 21–22, 2005	**Employee Benefits in Mergers and Acquisitions**, Plaza Hotel, New York, NY	ABA Joint Committee on Employee Benefits www.abanet.org/jceb 202-662-8640
April 27, 2005	**"Last Wednesday" Teleconference Series: International Tax Topic TBA**	ABA Tax Section www.abanet.org/tax 202-662-8670
April 28–29, 2005	**How to Handle a Tax Controversy at the IRS and in Court**, Astor Crowne Plaza, New Orleans, LA	ALI-ABA www.ali-aba.org 800-253-6397
May 4–6, 2005	**ERISA Basics**, Courtyard Marriott Magnificent Mile, Chicago, IL	ABA Joint Committee on Employee Benefits www.abanet.org/jceb 202-662-8640
May 19–21, 2005	**May Meeting**, Grand Hyatt, Washington, DC	ABA Tax Section www.abanet.org/tax 202-662-8670
June 2–3, 2005	**Third Annual International Tax Institute**, 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**	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, **September 28–30**, Location TBA
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

INTERVIEW WITH IRS COMMISSIONER MARK EVERSON

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

MARK EVERSON

INTRODUCTION: Commissioner Mark W. Everson, who was confirmed as the 46th Commissioner of Internal Revenue on May 1, 2003, brings to the position both a long record of public service as well as significant management experience in the private sector. Commissioner Everson began his career as a CPA with Arthur Andersen after graduating from Yale, where he majored in history, and NYU Business School, where he received a Master's degree in accounting. Immediately before his appointment he was serving as Deputy Director for Management at the Office of Management and Budget and had previously served as controller of the Office of Federal Financial Management. Under the Reagan administration, Commissioner Everson held several positions at the U.S. Information Agency and the Department of Justice, including Deputy Commissioner of the Immigration and Naturalization Service. His private sector experience includes serving as group vice-president, finance, of S.C. International Services, a privately owned Dallas-based food service company, and as an executive of the Pechiney group, a French industrial group, in the U.S. as well as in France and Turkey.

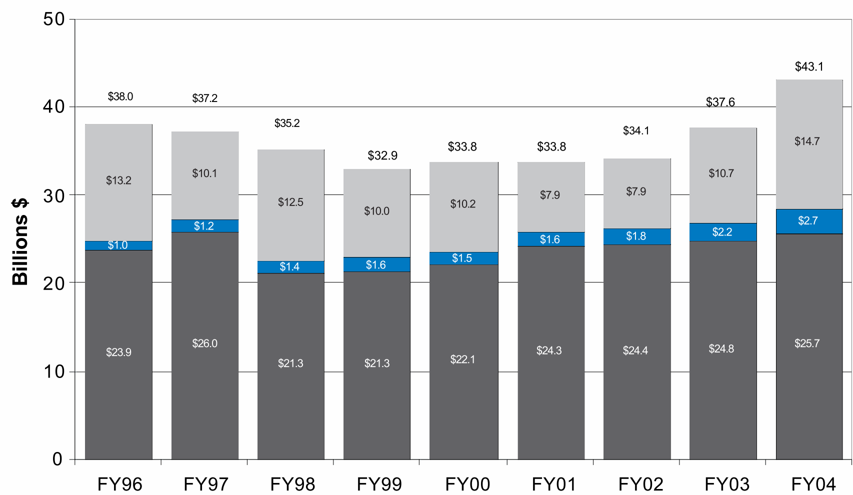
Q Good morning, Commissioner. Thank you very much for meeting with us today.

A Thank you.

Q Are there any remarks you would like to make at this time?

A I just would say this is an important time for the IRS. In the mid- to late 90s, there was a lot of concern about the services that the IRS was providing or failing to provide to taxpayers and to practitioners. There were also concerns, some of them unfounded, about intrusion of taxpayer rights by Service enforcement personnel. The combination of these two factors—the assertion of charges, some of which were unfounded, and a real lack of service that was in the system—gave rise to extensive Congressional hearings and a new law, the IRS Restructuring and Reform Act of 1998. In the last six years, the IRS has worked hard to improve services to taxpayers, and while it has done that, it has been reorganized. It is now organized around taxpayer segments. In bringing up those service levels, regrettably this single-minded focus resulted in a real decrease in enforcement. This is an important time now because we are re-centering the agency to have a balanced approach that recognizes the importance of service but also is augmenting enforcement so that we're doing both. We say that service plus enforcement equals compliance. Getting this balance right, making sure we're adequate in our attention to both missions while still respecting taxpayer rights, is something that's very important for us.

IRS Enforcement Revenue



Enforcement revenue provides a greater than 4-to-1 return from a $10.2 billion IRS budget.

■ Collection ■ Document matching ■ Exam and Appeals

Q Thank you. Could you describe your senior level staff and the functions they perform?

A After I came to the IRS, I created a second deputy position. So there are two Deputy Commissioners. We have one Deputy Commissioner for Services and Enforcement who supervises the four business units organized around the taxpaying segments like Large and Mid-Sized Businesses, as an example, plus Criminal Investigations, plus our Office of Professional Responsibility. The current deputy is Mark Matthews, who has a strong law enforcement and managerial background.

The other job is a structure that's not, to my knowledge, in use anywhere else in government right now, but I think it's working very well. We have a Deputy Commissioner for Operations Support where all of the staff functions are integrated under one person at the deputy level. That's the CIO; the Human Resource job; Mission Assurance, which is our security; the Chief Financial Officer; and something we call Agency-Wide Shared Services, which are things like procurement and facilities management. The person that we put in charge of that, John Dalrymple, was running one of our big business units before he came over to do this in June of 2003. This has integrated the efforts of the staff functions and made them much more supportive of the true interest of the business units, so you can drive efficiencies and performance much more. This is starting to work, and it supports our three strategic objectives: 1) improving service, 2) enhancing enforcement, and 3) modernizing the IRS. This change makes the modernization efforts, both in terms of our workforce and our IT Systems, much more manageable.

I have several operations of the agency that report directly to me because I think that that's appropriate because of the nature of their work. That includes the Chief Counsel, the Taxpayer Advocate, Appeals, EEO and also Research, as well as our Communications and Liaison Shop, the people who work with outreach to stakeholder groups and also with the Hill and the media.

Q The President has stated that he intends to pursue fundamental tax reform. What role in this process will you and the IRS play, and what reforms do you foresee?

A I think it is too early to tell what reforms will actually grow out of this process. I am heartened that the President has identified tax reform as a major second term objective. I think one element of this is clearly simplification. We believe that when we say we want to provide better services to taxpayers that service means helping people understand their obligation and facilitating participation in the system. Clearly, an important component of that is simplification and having a system where people know what their obligation is and how they have to comply with the law. So we are all for reform. Our role would be not to drive a particular policy option. It will be to help the Treasury Secretary and the people who look at this assess the different policy options from a point of view of administrability by the IRS and also from a perspective of whether changes will help increase compliance.

Q Do you have any concern that the LMSB program to obtain currency of audits will result in agents missing important issues?

A I think currency is an important initiative. Compliant taxpayers have every right to expect that their returns can be closed out in a shorter period than 5, 6, 7, or 8 years, which is the case right now. On the other hand, it's too late to address problem compliance areas if they have already been in existence for 4 or 5 or 6 years. So we need to get faster. We need to have more of a real-time audit process. This will require a lot of change. We are going to be very careful to make sure that we don't compromise the integrity of the audits. Our professional people, I believe, can do this work without missing what is a material problem in a return. It may, however, involve some adjustment to understand that nailing down every last nickel is not necessarily as important as doing the work, identifying the big issues promptly, handling the material items and then touching another taxpayer. Right now, if you look at corporations in the segment of $10 to $250 million dollars of assets, the audit coverage rate is once every 20 years. That's not an adequate level. We need to do more. So one way to do that is to improve the currency of our work, and, in fact, if you look at our enforcement results for fiscal year 2004, we were able to drive down the time devoted to the average elements being audited but at the same time drive up the tax assessed. That's what we need to do.

Q You have been an outspoken critic of tax shelter promoters and professionals who advise them. Do you think that the criticism that the IRS took from Congress prior to the 1998 restructuring had anything to do with decreased enforcement that permitted some of the shelters to proliferate?

A I think there was a combination of factors that led to the proliferation of these abusive shelters. I think clearly over a period of decades there's been a change—what I call an erosion—in the standards and professional ethics of some, not all, but way too many, attorneys and accountants who work in this area. When I started my career in the mid-70s in New York with Arthur Andersen, which at the time had an impeccable reputation, the standards were clear. Your number one obligation as a professional was to help your client adhere to professional standards and make sure that they followed the law. And then, if you could, you attempted to differentiate your firm, whether it was Arthur Andersen or PriceWaterhouse or Ernst & Ernst or Arthur Young or Deloitte Haskins themselves or any of the big New York law firms, whatever

it was, it was all the same deal. Everybody understood what their role was and that was different from the role of an investment banker or someone else who was taking financial risk in a transaction and interest in a value creation.

Now what has happened is that over a period of time that model has changed to where the discussion has been about risk management and value creation. I believe that that shift has damaged those two important professions, accounting and the law, and it has resulted in a series of incremental changes. And no one stood up and said, "Hey, this is getting to a bad mix where people are tempted to do more than they should in some of these areas." The other thing that happened here was the penalties for failing to comply with things like IRS registration and list maintenance requirements weren't adequate until just recently, when the new Jobs Act was enacted. So all this came together at a time when there was what some call a culture of greed in terms of what was going on in the country, and a lot of bad products were created. A great example is Son of Boss, which is clearly way over the line; everybody agrees on that, nobody defends Son of Boss.

The overhang from the congressional hearings clearly contributed to a reticence on the part of the IRS to do its job. We had to improve services, we worked on that, but, at the same time, it wasn't lost on some of our front-line personnel that there was a risk associated with enforcing the law, at least in some corners. I think that is different now. I think that in the last couple of years that corner has been turned, and there's a bi-partisan recognition on the Hill now that the IRS has to enforce the law, but it has to provide services to taxpayers. That's why our working equation is service plus enforcement equals compliance—not service or enforcement. It's got to be centered right down the middle, and our activities have to respect taxpayer rights, which are very important.

Q You are the second Commissioner who did not come from a tax background. What is your opinion of the movement away from that model towards selecting Commissioners?

A I think that one of the important contributions of RRA '98 was to establish a five-year term for the Commissioner. That bridges, obviously, presidential terms, potentially parties, and sends a strong signal to the bureaucracy that the Commissioner is going to be around and that when he or she articulates an agenda he'll be there, or she'll be there, with enough time to get it done. And if you look at what the IRS has been doing over the course of the year 2004, we've been building our program and starting to execute it. Around town, in some instances, that's been pretty tough because people were waiting to see what would happen with the election. So I think that's a good reform. The other piece of it is a recognition that it's a large organization, it's multi-faceted, it has over 100,000 people, over a $10 billion dollar budget. It's a large management leadership challenge. I think that you need to have someone who's comfortable taking on those challenges in the job. That doesn't mean a tax practitioner couldn't have that set of skills, but it might mean that someone who is primarily interested in the interpretation of the Code or the development of policy per se wouldn't be as inclined to address some of the fundamental management issues that are so important to delivering good service and delivering adequate enforcement.

Q As the IRS increases its emphasis on enforcement will it decrease its pursuit of improved customer service?

A We're going to strike a balance between providing both service and enforcement, but the trick here is—in a resource constrained environment—we're not going to be able to invest more money into services, so we need to make productivity improvements, restructure our workforce, and get more out of our technologies. It's going to be tough to do this, the President asked for more money for the 2005 budget; Congress failed to provide much of that request. I think that was shortsighted.

Q What kind of impact has the budget situation and long-term decline in staffing had on agency operations?

A The front-line enforcement staff—that is to say revenue agents who do audits, revenue officers who collect monies due and criminal investigators who prepare cases for possible prosecution by the Justice Department—they all decreased by over 25% in the several years following 1996. We're starting to bring those back up for the very first time at the end of the latest fiscal year; we had more enforcement personnel on board than the year before. We are augmenting the enforcement activities through better prioritization of our work, through the same kind of business and process reengineering that we did on the services side, and we're seeing results. Our enforcement revenues, those are the monies that come back into the government, they increased significantly, over 15% in the year 2004. They increased to over $43 billion dollars. That's greater than a 4 to 1 ratio compared to our whole appropriation, which includes our outreach and educational activities, not just our enforcement work. So there's a very big return here, but it's not recognized in the political process because of the budget scoring—that's to say the future budget deposit projections don't recognize the extra revenues we will get from investing in that personnel. It only recognizes the fact that we're going to spend an extra $400 million on enforcement. That's nuts because this is the top line of the government, and in a time of budget deficits you clearly want to make sure you're adequately invested to bring in those monies that are due. We're not talking about getting money that is not due to the government. These are

monies that are due in accordance with existing law.

Q Should the Hill treat the IRS differently because it takes in more than it spends?

A Because we're so large, people say, "Well you must have the money"—that's another reason why it's so important to modernize it. I have to convince the Congress, and I have to convince the White House, OMB and Josh Bolton that I'm running the agency effectively. Because otherwise they're going to say to me, "Mark—you guys are just wasting money everywhere. Why should we give you more until you demonstrate that you're running it efficiently." So there are two challenges. You have to run the agency correctly, and you need to run the agency correctly to demonstrate you're spending the taxpayer monies wisely before you can actually ask for more funding. That's why these two strategic goals we have of improving services and enhancing enforcement are supported by modernization, which gets to the efficiency question both in terms of the Constitution, your work force and the architecture and the effectiveness of your systems.

Q What impact do you think the changes to Circular 230 will have on taxpayers?

A We have four strategic priorities within the overall enforcement role, and the second one is to assure that attorneys, accountants and other tax practitioners adhere to professional standards and follow the law. The broadening of our authority in the new Jobs Act will certainly contribute to better oversight in the practitioner community. So I think the changes in Circular 230 will be helpful, and I frequently get feedback from people who are happy about this because they feel that they've been placed at a competitive disadvantage in recent years by those who have been more aggressive—and in some cases, improperly so—at promising the elimination of tax, which just wasn't proper. So I think these are good changes; I'm really pleased that the Congress did that and also that it put in the penalties that it did in the registration and list maintenance requirements. I think this will both increase our ability to do our job and, at this point, the penalties will cause people to think twice. If you go back to the Levin hearings in the fall of 2003, that clearly demonstrated that in some circles there was a feeling that even if this is wrong, even if it's illegal, it doesn't matter because the IRS isn't going to come after us and even if it does, the penalties are de minimis. There are actually written documents that said this. So that's a pretty shocking thing for professionals to say that, let alone write it down. What it says is that we got to a point in our system where it's like driving by a state trooper. You see that state trooper under the bridge, and you don't slow down; you say, "It doesn't matter, I can just outrace that guy." Now that is pretty blatant. So I think that the changes in Circular 230 and the changes in the penalties are, sadly, clearly documented as being necessary.

Q Any concluding thoughts?

A I would say that I appreciate the role of the ABA Tax Section. It plays an important role in the process. It provides regular feedback on a series of issues. I meet with the leadership every several months, and I think we have a good, healthy dialogue. We don't always agree on everything, but I feel that we do have a good dialogue, which helps me understand what the profession thinks is important in terms of how we're administering the tax code. Thank you. ■

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NEW PROGRAM

Please visit the website for a complete schedule for the May Meeting. Friday programs will be held from 9:30am–12:30pm and from 3:00pm–6:00pm, and the Friday Section Reception will be held from 7:00pm–8:30pm. Note these new additions to the program.

Friday, May 20 **Complimentary Breakfast with Hon. John W. Snow, Secretary of the Treasury**

Saturday, May 21 **Employee Benefits Luncheon with Michael J. Graetz, Justus S. Hotchkiss Professor of Law, Yale Law School, on Social Security Reform**

Saturday, May 21 **Joint Luncheon – Standards of Tax Practice and Civil and Criminal Tax Penalties with Cono Namorato, Director, Office of Professional Responsibility, IRS**

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SPECIAL REPORT: ATTORNEY-CLIENT AND WORK PRODUCT PRIVILEGES—OVERVIEW, TAX PRACTICE PRIMER, AND WHAT REMAINS AFTER THE TAX SHELTER ASSAULT*

INTRODUCTION: On Wednesday, April 13, 2005, at 1:00 pm EST, the Tax Section together with ABA-CLE will sponsor another in its annual **Tax Link Live** teleconference series. This special, 90-minute ethics program will feature a discussion on *"Attorney-Client and Work Product Privileges: Overview, Tax Practice Primer, and What Remains After the Tax Shelter Assault,"* which will be led by **B. John Williams**, Shearman & Sterling LLP, Washington, DC, and **David W. Aughtry**, Chamberlain, Hrdlicka, White, Williams & Martin, Atlanta, GA, with **G. Michael Yopp**, Waller, Lansden, Dortch & Davis, PLLC, Nashville, TN, moderating. There will be ample opportunity for questions from those who are participating in the teleconference. The following Report constitutes the material for the program. For details on registering and obtaining CLE ethics credit, please see the ad following this Report on page 23.

GENERAL OVERVIEW

A recent series of cases involving tax shelters and privilege have highlighted the importance of understanding the attorney-client and work product privileges for a tax practice. This article provides a general overview of the privileges and their application in a tax practice.

Attorney-Client Privilege. Wigmore on Evidence sets forth the classic formulation:

> When legal advice of any kind is sought from a professional legal advisor in his capacity as such then the communications relating to that purpose, if made in confidence by the client are, at the client's insistence, protected from disclosure by the client or the legal advisor unless the privilege is waived.

Two other aspects of the privilege should be noted. One, the Tax Court regards the attorney-client privilege as a mere rule of evidence. Two, the privilege covers communications much more narrowly than the attorney's ethical duty to keep client communications confidential. Thus, an attorney may be ethically required not to divulge a client confidence even where privilege has been waived.

The purpose of the privilege is to facilitate a client's seeking legal advice free of fear that the information provided to the attorney could be used to the client's detriment without his or her consent. *See* Upjohn Co. v. United States, 449 U.S. 383 (1981). The privilege also works to protect communications from the lawyer to the client that would reveal the nature of the client's communications. *See* Alexander v. F.B.I., 198 F.R.D. 306, 309 (D.D.C. 2000).

Work Product Doctrine. The formulation of the Work Product Doctrine is found in Hickman v. Taylor, 329 U.S. 495 (1947). Under this doctrine, the work product of an attorney prepared under the direction of the attorney or his or her staff in anticipation of litigation is protected from disclosure unless the other party demonstrates a need for such items to prepare his or her case, or the other party is unable to obtain the substantial equivalent. The purpose of the doctrine is to promote uninhibited, thorough, trial preparation. The work product doctrine is predicated on preventing an unfair advantage to a party's opponent.

Tax Advisor Privilege – IRC § 7525. The communications that a taxpayer has with a federally authorized tax practitioner (e.g., accountant, enrolled agent) that would be covered by the attorney-client privilege if they had been with an attorney are privileged, *but* only in civil tax proceedings (e.g., not in SEC or criminal tax proceedings), *and* not if the communications are made in connection with the promotion of a corporate tax shelter as defined in section 6661. The purpose of this privilege is to ensure that the right to privilege regarding tax advice before the Internal Revenue Service does not depend on the type of advisor. Because the client's expectation of confidentiality is a foundational part of the privilege, it is unclear how effective section 7525 is in protecting communications with practitioners whose firms are also financial auditors.

* Adapted by G. Michael Yopp from papers presented at the 2004 Tennessee Federal Tax Institute by B. John Williams and David W. Aughtry.

APPLICATION OF PRIVILEGES AND WAIVER OF THE PRIVILEGES IN TAX CASES

In every tax practice, the practitioner should be aware of implications for his client's communications. A brief discussion of these follows.

Beware of Waiver. Any action inconsistent with the maintenance of a privilege may constitute waiver and that waiver may extend to the entire subject matter. Bernardo v. Commissioner, 104 T.C. 677, 682 (1995), *citing* In re Sealed Case, 737 F.2d 94, 98-99 (D.C. Cir. 1984).

a. At least in the Tax Court, the party asserting the privilege bears the burden of proving the negative that he has not waived it. A system of segregating privileged material from non-privileged material may be essential for such proof.
b. Even though the privilege always belongs to the client and the lawyer is not free to waive it without client authorization, a third party is entitled to enforce a waiver based on the actions of that same lawyer as an agent with apparent authority. Hartz Mountain Indus. v. Commissioner, 93 T.C. 521, 525 (1989).
c. Under the precedent of the D.C. Circuit—which governs evidentiary rulings in all Tax Court cases –even an *inadvertent waiver* by the lawyer (or the *Kovel* CPA) generally constitutes an enforceable waiver. *In re Sealed Case, supra*.
d. That waiver generally extends to the entire subject matter. *Bernardo, supra*. *But see*, Long-Term Capital Holdings v. United States, 2003 U.S. Dist. LEXIS 14579 (D. Conn., May 5, 2003) (Disclosure of gist of "more-likely-than-not" tax opinion to auditors did not constitute waiver as to entire opinion).

The *Kovel* Doctrine: The attorney-client privilege will not be waived if communications are shared with a third-party expert who is serving as an interpreter to facilitate confidential communications between the client and the attorney. *See* United States v. Kovel, 296 F.2d 918 (2d Cir. 1961) (Friendly, J.). Consequently, it is routine for attorneys to retain experts, such as accountants, to provide non-legal advice in connection with the preparation of a case. Under the *Kovel* doctrine, these experts' work and advice can be covered by the attorney-client and work product privileges.

Bills and Invoices. IRS agents routinely ask for invoices relating to all payables. Be aware that the attorney's invoices may describe substantial confidential information.

Receipt and payment of a lawyer's bill are generally not privileged. United States v. Ellis, 90 F.3d 447, 450-51 (11th Cir. 1996) ("receipt of attorney's fees normally [is] not [a] privileged matter"); Chaudhry v. Gallerizzo, 174 F.3d 394, 402 (4th Cir. 1999).

The descriptions in the invoices can be privileged—provided that privilege is not waived. Clarke v. Am. Commerce Nat'l Bank, 974 F.2d 127, 129 (9th Cir. 1992) ("[C]orrespondence, bills, ledgers, statements, and time records which also reveal the motive of the client in seeking representation, litigation strategy, or the specific nature of the services provided…fall within the privilege"). Providing such statements to auditors waives any privilege. Generally, the best course is to segregate invoices describing services performed from invoices showing the amounts due.

Tax Opinions. Tax advice and tax opinions by counsel can be privileged. United States v. Tel. & Data Sys, Inc., 2002-2 U.S.T.C. ¶ 50,569 (D. Wis. 2002); Wojdak v. First W. Gov't Sec., Civ. Action No. 83-1076, 1991 U.S. Dist. LEXIS 11482, *4-5 (E.D. Pa., Aug. 15, 1991) (draft tax opinions protected by attorney-client privilege because they "were for the purpose of giving legal advice to a client, and were expressly treated by the sender and the recipient as confidential").

Audit or Tax Return Work Papers Not Protected. Accountant's work papers and work product generally are not privileged unless derived from the attorney's work product privilege. United States v. Arthur Young & Company, 465 U.S. 805 (1984). The Supreme Court in *Arthur Young* noted that guidelines issued by the IRS during the course of litigation provided that the examiner should seek tax accrual work papers only in "unusual circumstances" and only as a "collateral source for factual data." *Id*. at 821 n. 17. This policy has recently been changed. In 2002, the IRS announced that it was modifying the policy. *See* Announcement 2002-63, 2002-27 I.R.B. 72. In particular, revenue agents may request tax accrual work papers if the return being examined involves a "listed transaction" at the time of the request.

What Constitutes Litigation? The work product doctrine requires that the product be prepared "in anticipation of litigation." What about a proposed transaction? The fact that a work product relates to a proposed transaction is just one factor that suggests it was not prepared in anticipation of litigation and is not, in and of itself, dispositive. United States v. Addmon, 68 F.3d 1495, 1502 (2d Cir. 1995) (corporate officer obtained tax memorandum regarding proposed transaction from accountant/lawyer at Arthur Andersen; the memorandum was held to be subject to the work product "privilege.")

Recent Court Opinions/Identity Privilege. Historically the IRS prevails in summons enforcement cases, and recently, that is where the war over privileges has been fought.

KPMG. In U.S. v. KPMG, LLP, 91 A.F.T.R. 2d 2003-317 (D.D.C. Dec. 20, 2002), the IRS moved to enforce a stock of IRS summonses relating to FLIP/OPIS BLIP and other structured transactions, and KPMG sought a protective order. KPMG asserted (i) the section 7525 Tax Practitioner privilege, (ii) the Attorney-Client Privilege, and (iii) what the Court labeled KPMG's "Own Privilege." The firm also sought to submit a categorical description of the privileged documents for *in camera* review by the Court, rather than a privilege log describing every document.

The District Court's opinion contains some faulty language and conclusions which imply that tax

advice associated with return preparation is necessarily not privileged—a result that seems to defy the distinction enacted by Congress between tax advice and tax return preparation. On that basis, the court generally rejected the claimed section 7525 privilege, required production of the KPMG tax opinions, but recognized the section 7525 privilege with respect to the outside attorneys' opinions.

The court also held that a lawyer is barred from practicing law as a member or employee of an accounting firm and on that basis, generally rejected the assertion of the attorney-client privilege and attorney work product doctrine by KPMG.

The court buttressed its denial of the attorney work product doctrine on the grounds that Section 7525 does not include a work product component and the documents were, in the court's view, not prepared in anticipation of litigation.

The court upheld elements of KPMG's "Own Privilege" relating to communications involving its General Counsel's Office relating to contracts, liability, etc.

Finally, the court rejected the request for a categorical privilege log, although it acknowledged the burden would be great.

BDO Seidman. In U.S. v. BDO Seidman, et al., 2004 U.S. Dist. LEXIS 12145 (N.D. Ill., Feb. 4, 2002), the District Court held that "the motivation is itself a confidential communication." The Court stated a four factor test for determining if a document was privileged:

a. Was the purpose of the tax practitioner's representation to provide tax advice?
b. Would revealing the taxpayers' names reveal their motives for seeking tax advice?
c. Have the taxpayers waived the privilege?
d. Was the document at issue communicated or generated for the purpose of preparing the taxpayer's tax returns?

In order for section 7525 privilege to apply, the answer to question 1 must be yes, to question 2 yes, to question 3 no, and to question 4 no. In United States v. BDO Seidman, 337 F.3d 802, (7th Cir. 2003), the Seventh Circuit affirmed the District Court's denial of the plaintiff's Motion to Intervene in an IRS enforcement action against BDO.

Arthur Andersen. In United States of America v. Arthur Andersen, LLP, 2003 U.S. dist. LEXIS 14228 (N.D. Ill., August 15, 2003), a District Court first held that intervenors may continue to use fictitious names in an action for enforcement of summonses against Arthur Andersen, LLP, that the section 7525 privilege applies, and that any information about the intervenors' identities is to be redacted before complying with the summonses.

Later the District Court withdrew this favorable opinion and issued an adverse Memorandum Opinion following the Seventh Circuit's BDO opinion. Ironically, the intervenors in BDO filed for *en banc* review by the Seventh Circuit *only ten days earlier* based on the uncontroverted fact that the disputed transactions were not "listed" at the time they were consummated and therefore, the investors did in fact expect their identities and activities to remain confidential.

Wachovia (Jenkens & Gilchrist). In John Doe #1 et al. v. Wachovia Corporation, 286 F. Supp. 2d 627 (2003), a North Carolina District Court denied investors injunctive relief in regard to preventing a bank from turning over investor lists, after determining that the law firm that issued "more likely than not" opinion letters to the investors did not enjoy a traditional attorney-client relationship with them. The court also held that the section 7525 privilege was inapplicable.

As the foregoing discussion demonstrates, every tax practitioner should be acquainted with the attorney-client, work product and tax practitioner privileges. Failure to do so could result either in wrongly advising a client that material will be privileged or in an inadvertent waiver of a client's privilege. ■

FROM THE **CHAIR**

FROM PAGE 3

and other IRS officials to discuss the then-proposed Circular 230 regulations and the Service's new initiatives aimed at promoting audit currency. In early December, we briefed Acting Assistant Treasury Secretary Greg Jenner, IRS Chief Counsel Korb, and other Treasury and IRS officials on guidance issues arising under the American Jobs Creation Act of 2004 that our committees had identified as areas where prompt guidance was needed. The list reflects another fine performance by our committees acting under a short time deadline.

CLE ON THE ROAD/ SECTION TELE-CONFERENCES

In November, we launched a CLE effort, "Tax CLE on the Road," designed to bring Tax Section CLE to members in cities where the Tax Section has not sponsored programs before. ABA member surveys have identified that practitioners prefer local CLE programming. Our pilot program on "Allocation-Based Versus Distribution-Based Partnership Agreements," was held in Saint Louis and Dallas. I would like to thank Bob McKenzie and Elinore Richardson for their leadership in this new effort. Mark Martin and Philip Wright assisted with local planning and sponsor-

SEE FROM THE CHAIR, NEXT PAGE

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FROM THE CHAIR

FROM PREVIOUS PAGE

ships. Our speakers, Barbara Spudis de Marigny, Rebecka Eggers, Paul Gordon, Dick Lipton, Tom Helfand, and Lewis Steinberg, provided a fine inaugural for the new program. We will keep you posted on where "Tax CLE on the Road" will travel in 2005.

The Section's "Last Wednesday" teleconferences continue to generate significant interest from our members around the country. Our planned February 9 teleconference on the recently-published Circular 230 regulations is part of this program. Consult the Tax Section website for information on these and other Section CLE opportunities. Our "Tax Link Live" teleconference will be held in early March (as advertized in this issue).

SAN DIEGO MEETING

As this issue goes to press, we will be in San Diego at the Section's Midyear Meeting where the panoply of interesting issues arising from the JOBS Act and the new Circular 230 regulations will provide much to discuss. ■

SPOTLIGHT ON COMMITTEES: DOMESTIC RELATIONS

by Toni Robinson, Hamden, CT

The Domestic Relations Committee can barely keep up with all the developments in its area. In addition to the controversy that has ensued since Massachusetts became the first state to approve same sex marriage, California is considering similar legislation and has adopted a new statute authorizing the equivalent of community property for unmarried partners. To add to these new state law developments, Congress enacted two major pieces of tax legislation in October. The first, the Working Families Tax Relief Act of 2004 contains many provisions affecting domestic relations planning; the second, the American Jobs Creation Act of 2004, also includes provisions of interest to our Committee.

A quick review of the Committee's activities should begin with the treatment of same sex and transgendered couples. Boston seemed the ideal venue for an examination of tax and estate planning for same sex and transgendered couples. Since Massachusetts began recognizing same sex marriages as a consequence of the decision of its highest court, there has been a great deal of confusion as to when these marriages will be recognized for tax (and other) purposes. Although federal tax law had long relied on state status for determining the right to file a joint return and the proper application of the rate tables, the Service has confirmed that federal law, the Defense of Marriage Act ("DOMA"), requires the federal taxing authorities to reject the validity of same sex marriages, even if they were legally authorized where performed (i.e., Massachusetts). (Letter from the Service to Eugene A. Delgaudio (June 14, 2004), available at http://www.publicadvocateusa.org/news/article.php?article-95.) For a discussion of the letter, *see*, Allen Kenney, *IRS: Joint Filing Not Allowed for Same-Sex Couples*, 103 TAX NOTES 1455 (2004). For a discussion of the letter's effect on the ability of legally married couples from treaty countries to file joint returns, *see*, Anthony Infanti, *Prying Open the Closet Door: The Defense of Marriage Act and Tax Treaties*, 105 TAX NOTES 563 (2004).

DOMA also allows states to refuse to recognize same sex unions for the purpose of such things as spousal shares at death, health directives, and custody of children. That is, a same sex couple may have all the rights of spouses within the jurisdiction where same sex unions are authorized, but outside of those geographic areas, same sex spouses will have to rely on some of the methodologies other unmarried partners have utilized, most importantly, contracts. During our Boston meeting we learned that even contracts may not provide the desired result because even the ability to make binding contracts may be hindered by individual state laws; Virginia, for example, as part of its ban on same sex marriage, also bars the making of contracts in order to accomplish a legal result that is a normal consequence of marriage. Participants in the Boston meeting also heard from a panel of experts on planning and drafting tax and estate planning documents for same sex couples. Participants in these programs agreed that the Committee should sponsor more panels to investigate further the topics raised at this first presentation.

More recently, in San Diego, the Committee discussed innocent spouse litigation, including Ewing v. Commissioner, 122 T.C. No. 2 (2004) (on appeal) in which the petitioner sought equitable relief at the discretion of the Secretary. After the Service denied relief, the taxpayer advanced some additional information that had not been presented to the Service before its ruling. The taxpayer's appeal asserted an abuse of discretion, with the Service arguing that it cannot abuse its discretion if the information is unknown to it.

The Committee's San Diego program also included an exciting panel on estate planning for high-income couples, who face uncertainty due to the possibility of permanent estate tax repeal and the increasing lifetime exemption amount. There was also a presentation concerning the new California Domestic Partner legislation that creates community property rights for domestic partners similar to those that exist for married partners. The panelists discussed this legislation and provided an update on the prospects for legalization of same sex marriage in California and the possibility that other community property states might follow California's action regarding the property rights of domestic partners.

Finally, the recent adoption of a unified definition of "qualifying child" affects many provisions in the Code, especially the various credits that apply to most low-income taxpayers. In addition to discussing this in San Diego, the Committee is exploring a joint meeting with the Low Income Taxpayers Committee. In future meetings the Committee also hopes to explore further the issues affecting transgendered taxpayers. Members interested in learning more about the Committee are welcome to attend its meetings or contact the Chair, Toni Robinson at Toni.Robinson@quinnipiac.edu. ■

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ABA Tax Section committees play a vital role in carrying out the Section's dynamic government relations and comprehensive CLE and publishing programs. Section Committees research new tax law, comment on regulations, prepare reports on current changes in the law within their specialties, develop CLE programs, and contribute to Section publications.

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GOVERNMENT SUBMISSIONS BOXSCORE

Since September 1, 2004, 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 — FALL 2004*

SUBMISSIONS TO U.S. TREASURY DEPT. AND IRS

I.R.C. §	DATE	TITLE	COMMITTEE	CONTACT
n/a	12/21/04	Proposed Changes to the Internal Revenue Service's Classification Settlement Program to Resolve Worker Classification Issues	Employment Taxes	Harvey J. Shulman G.J. MacDonnell
1374	11/23/04	Adjustment to Net Unrealized Built-In Gains and Losses	S Corporations	Kevin D. Anderson
951	11/22/04	Pro Rata Share Determinations Under Subpart F	Foreign Tax Credit and Subpart F Task Force; FAUST	Elinore Richardson Carol Tello Lowell Yoder
2632	10/12/04	Proposed Regulations Relating to the Election Not to Have Automatic Allocation of Generation-Skipping Transfer Tax Exemption Apply to Certain Transfers to a GST Trust (Reg-153841-02)	Various	Richard S. Franklin Steven B. Gorin Trent S. Kiziah Melissa Langa Carolyn M. Ohlsen Mark Shiller Lloyd Leva Plaine David Pratt Diana S.C. Zeydel
n/a	9/2/04	Identification of Potential Increased Thresholds and "Safe Harbors"	n/a	Samuel L. Braunstein

SECTION POLICY AND BLANKET AUTHORITIES — FALL 2004**

TO	DATE	TITLE
Finance/Ways and Means	11/29/04	Letter and Report Regarding Alternative Minimum Tax
IRS Oversight Board	11/22/04	Letter to IRS Oversight Board Regarding IRS Strategic Plan
Finance/Ways and Means	10/18/04	Letter Regarding H.R. 1308 — Working Families Tax Relief Act of 2004
Senate Finance Comm.	9/15/04	Supplemental Response to Senate Finance Committee Roundtable on Nonprofit Organizations, July 22, 2004

* 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.

** The submissions listed in this index have been presented on behalf of the ABA Section of Taxation. They have not been approved by the ABA House of Delegates or Board of Governors and, therefore, should not be construed as representing the policy of the American Bar Association.

NEWS BRIEFS

FREE LEXISNEXIS™ MEMBER BENEFIT

For a limited time, Tax Section members can enjoy free access to Matthew Bender analysis of the Working Families Tax Relief Act of 2004 and the American Jobs Creation Act of 2004 courtesy of LexisNexis™, the Tax Section's primary legal publishing sponsor. Go to www.abanet.org/tax to download your copies.

VOLUNTEER INCOME TAX ASSISTANCE WANTS YOU

The Tax Section's Pro Bono Committee is once again teaming with the IRS to encourage tax professionals to assist needy taxpayers. With VITA's new relaxed training requirement, it is now easier than ever to participate. For details, please visit the Tax Section's VITA webpage at www.abanet.org/tax/vita.

TAX TELECONFERENCE TAPES AVAILABLE

The ABA Tax Section and the Center for CLE are pleased to offer audiotapes from the Tax Section's monthly "Last Wednesday" teleconference series. Audiotape packages include program materials, and, in some cases, CD and online formats are also available.

Consider the following recent programs:

- Strategies for Avoiding and Handling Criminal Tax Matters
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Order any tape in the series by phone at 800/285-2221 or online at www.abaclecatalog.org.

REAL ESTATE FINANCING STRATEGIES — JUNE 15

On June 15, 2005 at 1:00 pm Eastern, the Tax Section is cosponsoring an ABA Connection teleconference on "Real Estate Financing Strategies." The ABA Journal article and teleconference will examine how like-kind exchanges have become the latest fad in real estate transactions, made possible under section 1031 of the Internal Revenue Code. These exchanges offer significant benefits for the disposition of capital assets, but they require care in handling. This program will discuss why 1031 exchanges are popular, how they work, who they work best for, and how they should be handled. Other recent developments in financing residential real estate purchases, and assessment of their effectiveness and potential pitfalls will be covered. CLE credit has been applied for in states that accept the teleconference format.

There is a $9.75 registration fee for the teleconference. To register, call the ABA at 800/285-2221 from 8:30 a.m. to 6:30 p.m. Eastern weekdays, beginning Monday, May 23rd or register online by Friday, June 10th at www.abanet.org/CLE/connection.html.

5TH ANNUAL TAX PLANNING STRATEGIES— U.S. AND EUROPE

LONDON, ENGLAND
APRIL 7–8, 2005

The ABA Tax Section together with the Taxes Committee of the International Bar Association Taxation Section are pleased to present the Fifth Annual Conference on "Tax Planning Strategies—U.S. and Europe," April 7–8, 2005, in London, England. This year's distinguished faculty will explore the following topics: Disclosure—The Next Step; Structured Finance: Recent Developments; Post Acquisition Restructuring; Transfer Pricing/APAs and Other Government Initiatives; EU Inequalities; and Property Investment. For more information, go to www.abanet.org/tax.

3RD ANNUAL INTERNATIONAL TAX INSTITUTE

FORDHAM LAW SCHOOL
JUNE 2-3, 2005

"U.S. Multinationals: Rethinking International Ownership and Operating Structures in Light of Recent Foreign Developments" is the focus of the Third Annual International Tax Institute sponsored by the ABA Tax Section, Fordham University School of Law, and the International Fiscal Association, U.S. Chapter. The first day's sessions will consider important issues for the U.S. multinational in completing startup operations or investments in businesses in Europe, Canada, Latin America, and Asia using selected jurisdictions and case studies. The second day will feature panels on ethics and international provisions in the JOBS Act and their impact on planning by the U.S. multinational for overseas investment, followed by a government roundtable with U.S. and foreign tax administrators. For information, go to www.abanet.org/tax. ■

TAX BITES

Compiled by Gail Levin Richmond, Fort Lauderdale, FL

TAX BITES TRIVIA QUIZ **ANSWERS & AWARDS**

Thanks to all who entered the Tax Bites Trivia Quiz we published in the Summer 2004 issue. First prize goes to Mary Monahan, Sutherland Asbill & Brennan LLP, Washington, DC. Second prize goes to Paul Decker, Goodwin Procter LLP, Boston, MA. An Editor's award goes to Tax Court Judge James Halpern, author of the *Heck* opinion, for reminding your editor that Korbel is actually sparkling wine. ■

1. *The Service conceded during litigation that a taxpayer could deduct cat food as an ordinary and necessary business expense. (The taxpayer was not a veterinarian, pet store, etc.) What type of business did the taxpayer run?*

The taxpayer who deducted cat food operated a junkyard or scrap yard. Seawright v. Commissioner, 117 T.C. 294 (2001).

2. *What estate tax value did the court assign to shares in the company that produced Korbel champagne?*

Korbel shares were valued at $32,174 each. Estate of Heck v. Commissioner, 83 T.C.M. (CCH) 1181 (2002).

3. *A multi-tasking taxpayer was a CPA, cab driver, and photographer. Which of these activities failed the hobby loss test?*

Neither accounting nor photography was treated as taxpayer's business. Burns v. Commissioner, 66 T.C.M. (CCH) 1337 (1993).

4. *A father and son played the same position for the same baseball team (but not simultaneously). The father's signing bonus generated tax litigation. Who are these players? What position? What team?*

The father-son duo was Cecil, Jr. (Randy) and Todd Hundley. Both were catchers, and both played for the Chicago Cubs. Randy's father (Cecil, Sr.), payments to whom were at issue, had also played catcher. Hundley v. Commissioner, 48 T.C. 339 (1967). Younger readers might be amazed to learn that Randy's 1960 signing bonus ($110,000) was considered "a huge bonus." 48 T.C. 346.

5. *A taxpayer's car was towed and crushed after the city pound failed to determine its ownership. In which city did that event occur?*

The car was towed and crushed in Chicago. Hananel v. Commissioner, 62 T.C.M. (CCH) 439 (1991).

6. *What did the subject of "Mommy Dearest" do to land in Tax Court?*

Joan Crawford tried to deduct a loss with respect to the rights to the Teacher Story. Crawford v. Commissioner, 20 T.C.M. (CCH) 740 (1961).

7. *A NBA expansion team owner claimed an amortization deduction for the cost of rights to participate in special veterans' and college drafts. Which team? What outcome?* **BONUS QUESTIONS:** *Who is the team's current owner? For what branded product is he famous?*

The Seattle SuperSonics claimed the amortization deduction. First Northwest Industries, Inc. v. Commissioner, 70 T.C. 817 (1978). The chair of the LLC that currently owns the team is Howard Schultz, who is better-known as the chairman of Starbucks Coffee. ■

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