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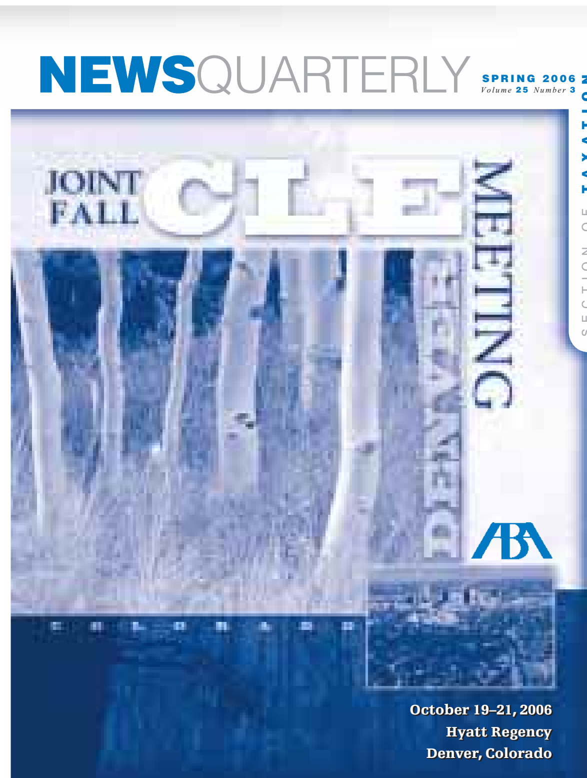

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FROM THE CHAIR

by Dennis B. Drapkin, Dallas, TX

DENNIS B. DRAPKIN

COMPLIANCE AND ETHICS INITIATIVES

With all the recent focus on the development and implementation of the final Circular 230 written tax advice rules, it is important to remember that Circular 230 imposes other ethical obligations on practitioners. Based on recommendations from former Section chair Dick Lipton, Council has approved creating a task force to consider and put into effect initiatives to promote practitioner compliance with these other Circular 230 ethical requirements. Karen Hawkins, former Vice Chair - Professional Services (and current liaison to the Office of Professional Responsibility), will head the task force, and former Section chair Steve Salch will serve as vice chair of the task force. The task force is expected to consider projects such as: practitioner obligations relating to due diligence, conflicts, client records and powers of attorney; practitioners who are delinquent in their individual filing obligations; assisting OPR in preparing training materials for its personnel; and helping to publicize OPR positions on specific ethical situations.

SURVEY OF IRS APPEALS PROCESS

There has been considerable publicity lately as to whether the IRS appeals function has changed in important respects and, if so, how these changes might affect the resolution of tax controversies. Appeals has traditionally served an important alternative dispute resolution function, fostering the settlement of tax controversies in a fair and efficient manner, thereby avoiding the need for expensive, time-consuming litigation. Under the supervision of Charlie Egerton, Vice Chair - Committee Operations, the Committee on Administrative Practice, with input from the Low Income Taxpayers Committee, has developed a survey to ascertain the recent experience of Section members with the efficacy and independence of the appeals process. The survey was developed with technical assistance from the American Bar Foundation, which has considerable expertise in creating surveys that are statistically meaningful. At the Midyear Meeting, Council approved going forward with the survey.

PATENTING TAX STRATEGIES

Much to the amazement of most tax practitioners, for several years now, the U.S. Patent and Trademark Office has been granting patents on tax planning methods. To intellectual property experts, however, this is not a surprising result, given the recent growth and court approval of so-called business method patents. The IRS reportedly has been following these developments and may be interested in providing input to the Patent Office as to whether a patent application covering a tax strategy satisfies the legal requirements for patentability. In view of the potential impact on tax policy and tax administration, I asked two of our Council Directors, Ellen April and Charlie Pulaski, to look into this subject and report to Council at the Midyear Meeting. Their report included valuable input from Professor Richard Gruner, an intellectual property expert at Whittier Law School. The sense of Council was that we should continue to investigate, and ascertain more widely how other professional organizations, as well as government officials, are reacting to this growing trend. We know, for example, that because the initial surge of patented tax strategies has focused on wealth transfer techniques, the Real Property, Probate and Trust Law Section is deeply concerned. We have also reached out to the Intellectual Property Law Section in an effort to coordinate our activities on behalf of the tax system with their expertise in the subject matter.

COMMUNITY OUTREACH TRAINING PROGRAM

For several years, the Real Property, Probate and Trust Law Section has provided community outreach continuing education covering subjects within its primary jurisdiction. RPPT offers multi-week programs in urban areas in cooperation with local minority and ethnic bar associations and all-day intensive programs at its section meetings. This past fall, RPPT invited the Tax Section to cosponsor these programs in order to expand their subject matter and take advantage of the CLE structure that RPPT has developed. Elinore Richardson, our Vice Chair - Professional Services, explored this opportunity with RPPT, and recommended to Council that the Tax Section join with RPPT in providing both types of outreach programs. Council agreed at the Midyear Meeting to go forward with the proposal. The Tax Section's Diversity

Committee will have principal responsibility for arranging for speakers on tax subjects. The first outreach program involving both sections will take place at the Fall 2006 Joint CLE Meeting with RPPT in Denver.

ABA FORMAL OPINION 346

ABA Formal Opinion 346 provides professional standards for tax shelter opinions given to third-party non-clients. It was last revised in 1982. In light of the promulgation of the final Circular 230 written tax advice regulations, the ABA Standing Committee on Ethics and Professional Responsibility, which has jurisdiction over ABA formal opinions, concluded that it was time to revisit and update Opinion 346. In addition, responding to a request made by a Senate subcommittee to the ABA to upgrade its standards of practice in light of tax shelter abuses, in 2004 the ABA formed a Task Force on Tax Shelter Ethical Responsibilities. In view of these developments, the Section's Standards of Tax Practice Committee has created a subcommittee to recommend revisions to Opinion 346. This project will be coordinated through Council, as well as with the ABA Standing Committee and the ABA Tax Shelter Task Force.

RECENT GOVERNMENT SUBMISSIONS

It has been a busy period for Tax Section submissions to the government. Our energetic committees have recently produced comments on a broad range of administrative and legislative subjects.

- The Low Income Taxpayers Committee prepared comments on proposed changes to collection due process procedures under sections 6230 and 6330.
- The Partnerships and LLCs Committee submitted comments on proposals addressing transfers of partnership equity for services, and also commented on Notice 2005-15 regarding "assets-over" partnership mergers.
- The Exempt Organizations Committee prepared comments on proposed regulations under sections 501(c)(3) and 4958, and also submitted comments on legislative initiatives included in S. 2020 affecting exempt organizations and charitable contributions.
- The Court Procedure and Practice Committee commented on proposed Tax Court rules regarding electronic filing of documents, and also prepared a letter to Chief Judge Gerber on privacy protection concerns in Tax Court filings.
- The Employee Benefits Committee submitted numerous comments on proposed regulations under section 409A regarding nonqualified deferred compensation arrangements.

IRS OVERSIGHT BOARD PUBLIC FORUM

The IRS Oversight Board held its annual public forum in Washington, D.C. on February 8, 2006. This year, in place of formal testimony, the Oversight Board convened two panels, one on the customer service needs of taxpayers and the other on measurements of tax administration. The Section was represented by former chair Pam Olson, who participated in the customer service panel, with input from several Section committees, including Administrative Practice, Low Income Taxpayers and Pro Bono. Among the themes that emerged from the panel were: the importance of customer service as a sound preventive strategy that reduces the need for additional enforcement down the road; open and frequent communication with stakeholders helps the Service avoid mistakes and improves efficiency; and greater discretion and empowerment of IRS employees may improve customer service and conserve resources.

HURRICANE KATRINA ACTIVITIES

As a result of the relocation of the Section's Midyear Meeting due to the impact of Hurricane Katrina, Council approved last fall a Tax Section contribution to Hurricane Katrina relief efforts based on attendance at the Midyear Meeting. Because of the extraordinary registration at that meeting, the Section contributed a total of $32,000 to the following organizations: Mississippi Center for Justice Hurricane Katrina Victims Legal Relief Fund; Southeast Louisiana Legal Services Corporation; Louisiana Recovery Authority Fund/Support Foundation of the Baton Rouge Area Foundation; and the Foundation for the Mid South. In addition, through its Katrina Task Force, the Tax Section has developed a mentoring program to assist local lawyers in the areas affected by the hurricanes to provide federal tax assistance relating to tax return preparation and the implementation of the numerous IRS special initiatives that address the impact of the storms.

LAW STUDENT TAX CHALLENGE

The closing rounds of the Section's 5th Annual Law Student Tax Challenge were held at the Midyear Meeting in San Diego. For the first time, LL.M. candidates were included in the program, competing against other LL.M. candidates. Over 40 J.D. and LL.M. participants prepared written submissions addressing the same complex international tax planning problem. The semi-finalists were invited to San Diego to make oral presentations to the "client," represented by a panel of experienced tax practitioners. We are grateful for the efforts of our Young Lawyers Forum in developing the competition and making it a continuing success. For a list of the winners and more details, please see the News Briefs at page 25.

CONTINUED ON NEXT PAGE

NOMINATING COMMITTEE REPORT

2006 – 2007 NOMINEES

In accordance with sections 6.1 and 6.3 of the Section of Taxation Bylaws, the following nominations have been submitted by the Nominating Committee for terms beginning at the conclusion of the 2006 Annual Meeting in August. Under the Section Bylaws, the current Chair-Elect, Susan P. Serota of New York, NY, will become Chair at the conclusion of the 2006 Annual Meeting.

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FROM THE CHAIR

FROM PAGE 4

MIDYEAR AND MAY MEETINGS

Despite changing the location and dates, the Midyear Meeting in San Diego attracted 1250 registrants, which was slightly more than last year. We are grateful for the extraordinary efforts of Section staff, led by Meetings Director Julie Hulsey, in making the arrangements.

We are looking forward to another outstanding meeting on May 4 - 6, 2006, in Washington, D.C. At that meeting, we will present the Section's Distinguished Service Award to Martin Ginsburg. In addition, Nina Olson, the National Taxpayer Advocate, will address the Section at its plenary breakfast.

STAFF ADDITIONS

We welcome the following new additions to the Section's staff: Bonnie Algera, Membership & Marketing Manager; Andrea Amato, Administrative Assistant; Emily Caldwell, Assistant Director of Meetings; Karen Gee, Technology Manager; and Deitz Lefort, Staff Counsel. ■

INTERVIEW WITH MILLIE SEIDMAN

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

MILLIE SEIDMAN

INTRODUCTION: Millie Seidman recently retired from the Tax Division of the U.S. Department of Justice after serving the Division with distinction for 50 years. Since 1985 Ms. Seidman had been the Chief of the Tax Division's Court of Federal Claims Section, where she supervised and coordinated litigation of large-dollar cases totaling (in 2005) more than $2 billion. Always a tax lawyer's lawyer, Ms. Seidman's technical skills were unsurpassed, and she was a recognized authority in many of the most complex areas of tax law. During her decades with the Tax Division, she relentlessly pursued the government's best interests, regardless of complexities or obstacles.

Q How did you come to work for the Tax Division?

A The answer goes back a long way. I decided I wanted to be lawyer because I did not want to be a secretary or a bookkeeper. Getting into law school was not that difficult, but it was statistically interesting. I went to Columbia. There were 265 people in my entering class in 1949. Thirteen of them were women—five percent. Actually, Columbia was relatively advanced in admitting women.

Then came the "looking for a job" part. At that time there was practically no interviewing at the law school. You received a list of firms, you took your resume and you walked around from firm to firm. I walked around from November to June of my third year until I finally got a job offer in June with a small firm, which only lasted for several months. Then they told me that someone was coming back from the Army and therefore I was let go. For the next two and a half years, I worked as what Columbia called an associate in law, which meant teaching legal writing to the first-year students.

Because I had heard that tax law was a good area for a woman, I took every tax or tax-related course at Columbia during this period. Actually, I was working towards a JSD (doctorate of jurisprudence). I did all the course work, but I never did my thesis because I came down to Washington, D.C., and loved working on cases.

I knew that the government was better at hiring women and one of the people at Columbia told me that the Tax Division was a great place to work. So I came down to Washington and went to the Justice Department. I was interviewed by the Civil Division, which offered me a job on the spot. I was interviewed by the Tax Division, which told me I was completely unqualified for the job. The Executive Officer looked at my resume. I had been on Law Review and had decent grades and had the additional tax-related courses. But I was completely unqualified.

I went back and got letters sent from the Dean at Columbia to every executive in the Justice Department with the exception of the Attorney General. I came back and spoke to the Assistant Attorney General and a couple of days later Tax gave me an offer. Incidentally, the IRS called me and said that they would have put me somewhere on the Joint Committee Staff. But I was very happy to go to work for the Tax Division.

I started working two weeks later in 1955. At that time, you just started working and all the investigation took place afterwards. Background checks and everything took place afterwards.

Q How was the Tax Division organized when you started?

A About the same way that it is organized now. There was an Appellate Section, a Criminal Section, one Trial Section which handled refund suits and another Claims Section which dealt with what was subsequently called General Litigation, and the Compromise Section, which subsequently became the Review Section and then the Office of Review.

Thereafter, the trial section was split geographically. Still later, the Refund Trial Sections were merged with the General Litigation Section, which made a great deal of sense.

Q How would you compare the types of lawyers attracted to the Tax Division today versus 30-40 years ago?

A The Tax Division has always been able to get good lawyers. Are they different today in any respect? Well, they do not smoke, they are more health conscious, and they go to the gym and work out. I'm not sure if I see a difference in where they come from, as between law firms or right out of law school.

In 1955, some of them were people who had come over from IRS in the 1930s, but there were many about my age.

Q Had there been any lawyers who had passed through your Division while you were here that went on to other careers that seem to have nothing to do with tax? One in particular is Sumner Redstone, who is now the CEO of Viacom.

A I really don't know. Over the years there were a number of people who left the Tax Division, went to a firm and came back and there were people who were hired from IRS. That was true in 1955 and is the same today. We still hire some people from IRS.

The number of people we get, and their quality, can sometimes be affected by whether or not there is a tremendous boom in law firm hiring, so a lot of the top people go to law firms. On the other hand, there are people who come from law firms and take a 70 or 80 thousand dollar decrease in salary to come to the Tax Division. The credentials of people the Tax Division hired the last year have been absolutely spectacular.

Q Some observers think the Tax Division has seen far fewer jury trials in the past 15 years than it used to see during 1960s – 1980s. Do you agree, and if so, do you have any idea why that is the case?

A I agree. There was a tremendous blossoming of District Court litigation in the 1960s. Actually, there were geographical differences depending on court congestion to the extent that District Court litigation generally moved swiftly in the South where you had a tremendous amount of District Court litigation and therefore jury trials. In courts where the docket was congested, there was less District Court litigation, and therefore fewer jury trials. That was my perspective.

Now the courts have enforced settlement conferences and mediations. That really has made a difference, particularly with respect to jury trials since all involve factual issues. They are the cases which can and do benefit most from mediation and settlement procedures.

Also the frequency of jury trials, like other tax litigation, is going to depend on the extent to which returns are audited.

Q How has the makeup of the Court of Federal Claims tax litigation docket changed over that same period, if at all?

A I don't think it has changed substantially. But you had a change in 1982 when the Federal Circuit and the Claims Court (now the Court of Federal Claims) were created. Under the "old" Court of Claims, if you moved for partial summary judgment, you could skip the trial section and go straight to the Court itself, which was rather attractive. But that is no longer possible. I had taken a Court of Claims case in 1960 and at that time plaintiff moved for partial summary judgment because he wanted to avoid going through the Trial Commissioner. You did not have that possibility after you had what were the Claims Court and the Federal Circuit.

Q How has the Tax Division's interaction and coordination with IRS and Chief Counsel staff changed over the years, particularly with regard to setting strategy on litigating particular cases?

A There has been a great deal more interaction recently and a great deal of very extensive coordination now, particularly because of the tax shelter cases. We can say that the IRS is very interested in our tax shelter cases and obviously we have to be coordinating in all the courts. There is much more coordination now than there used to be, and it is a really active coordination. That would have started certainly in the last few years.

Q The IRS and the Justice Department sometimes have different perspectives on litigation strategy and arguments. Who controls those decisions?

A The Justice Department has good trial lawyers that look at the strengths and weaknesses of a case and may tend on occasion not to want to pursue the government position in a case that the Treasury might want pursued.

In my opinion, the IRS is our client. It is not very good to have conflicts with the client. Many conflicts have been resolved by settlement. And in settlement, generally, but not always, you could reach agreement. You can't always reach agreement within the Division, either. But generally with respect to settlements, one side could convince the other. And if not, one could live with it.

The Justice Department does have the last say, of course, because the 1933 Executive Order 6166 gave jurisdiction to the Justice Department, and in cases where we have jurisdiction we would have the last say.

Q In your career have you had much contact with the Joint Committee on Taxation, in connection with its refund settlement review function? Please describe the type of contact you have had.

A Actually, relatively little since I became chief of what was then the Review Section, simply because, frankly, we write such good memoranda that the Joint Committee rarely has had questions. I spoke with John DiCicco, who is now Chief of Review, to see whether things have been different more recently. He confirmed that the settlement people have a very good relationship with the Joint Committee. Generally someone from the Joint Committee calls up and asks the Review attorney a question about the case. Normally, those questions are resolved amicably. In the past 30

INTERVIEW WITH **MILLIE SEIDMAN**

years, I have been to a meeting with the Joint Committee only twice, once when I was in Review and once when I was in the Court of Federal Claims Section. I do know that previously there had been a strong disagreement as to two cases, but that was a long time ago.

Q Do you see any parallels or differences between tax shelter litigation in the 1970s and the same today?

A I see more differences than I see similarities. The 1970s tax shelters were much simpler. They frequently involved questions like valuation. They were sort of retail operations. Your insurance agent might suggest it. You had individuals involved and $25,000 or $50,000 would be the investment in a tax shelter. There were very small investors in tax shelters and very simple issues.

Now it is infinitely more complicated. It is a search for loopholes in the law in my perspective. You have much more complex structures, much more complex arguments and a different class of people are litigating.

Q Have the federal courts changed much, from your perspective, in their approaches to tax cases over the years?

A I think in the post WWII years, we used to win more cases than we do today. You had more tax cases in the Supreme Court, and the Supreme Court generally decided in favor of the government. But I cannot compare the circuits or the trial judges.

Q What is your general philosophy about going for cert on tax cases? Do you have an overall test that you apply to a case to determine whether it is a good one for cert?

A In my view the questions are: Is the decision grievously wrong? Is there a lot of money involved? Is it a really important principle? Is it unlikely that there will be a conflict of decisions after a Federal Circuit decision adverse to the government? ■

SECTION SURVEY ON APPEALS PROCESS

The Section of Taxation will distribute a questionnaire to conduct a survey this spring on practitioners' experiences with the IRS Office of Appeals. If you receive the questionnaire, we encourage you to complete and return it. The questionnaire will be sent from the Section either by e-mail or regular mail. Your participation is critical to the survey results, which will be used to inform the Section on the Appeals process.

If you receive the questionnaire, but have not had experience with Appeals, please answer the initial questions and return it so that we can have an understanding of the overall frequency of appearances that Section members have before Appeals. We appreciate your interest and contribution to this important project.

POINT & COUNTERPOINT:
CONSUMPTION VERSUS INCOME TAX

INTRODUCTION: The term "tax reform" has many meanings. Depending on one's viewpoint, it might imply simplification, rate reduction, or eliminating the double tax on corporate income. The President's Advisory Panel on Federal Tax Reform proposed changes to make the "code simpler, fairer, and more conducive to economic growth." One of its proposals, the Growth and Investment Tax Plan, is a "blended structure that would move the current tax system towards a consumption tax ...." Although it did not emerge as one of the two recommended systems, a Progressive Consumption Tax Plan also received Panel attention. This Point & Counterpoint addresses the consumption versus income tax debate in a unique fashion. Jack Cummings first provides pro-consumption tax quotations from writers spanning several decades. He then offers his own views in opposition to replacing the income tax with a consumption tax. Readers are encouraged to submit additional arguments, which may be published in a subsequent issue.

—Gail L. Richmond, Fort Lauderdale, FL

POINT: A POTPOURRI OF PRO-CONSUMPTION TAX VIEWS

Report of the President's Advisory Panel on Federal Tax Reform 152-153 (Nov. 2005):

The key difference between an income tax and a consumption tax is the tax burden on capital income. An income tax includes capital income in the tax base, while a consumption tax does not. Taxing capital income reduces the return to savings and raises the cost of future consumption relative to current consumption. This is likely to cause people to spend more and save less, thereby depressing the level of capital accumulation. ....

Although a consumption tax would remove the tax bias against savings and level the playing field between different types of investments, it is important to recognize that an income tax and the type of consumption tax discussed here would both tax a significant portion of the return to capital. To understand why, it is helpful to distinguish four different components of the return to capital. The first is the "normal," or risk-free, return that represents compensation for deferring consumption. This is sometimes described as the "return to waiting." The second is the expected risk premium for a project with uncertain returns—the return to risk taking. The third component is "economic profit" and represents returns due to entrepreneurial skill, a unique idea, a patent, or other factors. This component is sometimes referred to as "supernormal returns." The last component is the unexpected return from good or bad luck. This is the difference between the expected return at the start of an investment, and the after-the-fact, actual return.

Warren Rojas, *Bushonomics 101: Using Taxes as the Ultimate Disciplinary Tool,* 99 TAX NOTES 1734 (Jan. 23, 2003), 2003 TNT 121-2 (Jan. 24, 2003)(both paraphrasing and quoting Grover Norquist, President, Americans for Tax Reform):

…the Republicans' virtually seamless antitax stance has helped galvanize the party and insulate any legislative efforts from being torn apart by corporate dissidents …. "We all work together against the other team," he said of today's tax-cutting gameplan. "And if yours happens to move now, mine will come later. So that has made everyone play with much less sharp elbows and a willingness to work together." ....“It sends a message of 'Calm down. ….'"

William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1120-1122 (1974) (footnotes omitted, italics in original):

The prevailing prescriptive model of a personal income tax is called an *accretion-type personal income tax,* and a model in which accumulation is comprehensively excluded is called a *consumption-type personal income tax.* The latter is also called a *cash flow personal income tax* because that describes its practical computation. …. The existing tax is a *hybrid personal income tax* since it conforms to the accretion ideal in some respects and the consumption ideal in others, but neither with any consistency.

The difference between an accretion-type and a consumption-type personal income tax involves only accumulation, and it is in an important sense only a difference of timing. If an item of accumulation is not reflected in taxable income [referring to a consumed income tax], the tax is not waived but only deferred. Under either kind of ideal, what is ultimately subject to tax is the same—funds or wealth available for private consumption. ....

Consumption is the major component of accretion for most taxpayers most of the time, and therefore under either ideal, the tax is in the

long run mostly a tax on household consumption. ….

I believe, for reasons to be developed, that the consumption model offers better solutions to the question of how to treat accumulation than does the prevailing accretion model.

U.S. Treasury, Blueprints for Basic Tax Reform 133-134 (1977) (emphasis added):

Corporations would not be taxed as entities under either the cash flow tax or the comprehensive income tax. However, under the cash flow tax, there would be no need to impute undistributed income to individuals because taxes would be assessed only on funds available for personal consumption. Consequently, a single cash flow tax applied at the household level could be accomplished without the rules for integrating corporate and household accounts that are conspicuous features of the model income tax.

The treatment of returns from corporate activity under the cash flow tax would be exactly the same as the treatment of returns from other kinds of investments. There would be no separate tax at the corporation level. Individuals would be permitted to purchase corporate stock through qualified accounts held with brokers. The initial purchase price would be deductible from the tax base at the time of purchase, and subsequent withdrawals from the account as dividends received, return of capital, or proceeds from the sale of stock would be added alike to the tax base. For stock purchased outside of a qualified account, no deduction would be allowed for purchases, and neither dividends nor proceeds of future sales would be added to the tax base. Capital gains and capital losses would, therefore, have no tax consequences.

Edward J. McCaffery, *Ten Facts about Fundamental Reform*, 101 Tax Notes 1463 (Dec. 22, 2003), 2003 TNT 246-36 (Dec. 23, 2003) (emphasis added):

….The other path laid out in *Blueprints* was to abandon the attempt to have an income tax altogether and move instead to a consistent consumption tax. This is the right path to take. ….

Liberals for their part are opposed to any such tax, both because of its flat rate, and because of the thought that a consumption tax ignores the yield to capital altogether, and that such a yield is the domain of the socially fortunate. So liberals insist on maintaining, even strengthening, a progressive income tax, with its corollaries: the gift, estate, and corporate income taxes.

But once we assume that we are going to have at least some progression in the rate structure [on wages], the traditional understanding of consumption taxes is no longer accurate. ....

An income tax falls on all labor market earnings and the yield to savings at the time they come into a household. Savers are hurt by the "double taxation" of savings, whatever the intended or actual use of the savings. Individuals, like the highly educated, who see their earnings come in relatively short, concentrated bunches, are hurt by the timing of the imposition of progressive rates. ….

A similar argument can be made against a separate corporate income tax. The problems with this tax begin with its uncertain incidence: *Since corporations are not real people, they do not really pay taxes. A corporate tax falls on workers and consumers, on capital generally, or on some combination thereof. To the extent it falls on ordinary workers and consumers, the corporate income tax's claims to fairness are questionable. But to the extent the tax does fall on capital, it does not do so in any individuated way.*

Daniel N. Shaviro, *Replacing the Income Tax with a Progressive Consumption Tax,* 103 Tax Notes 91 (Apr. 5, 2004), 2004 TNT 66-48 (Apr. 6, 2004):

The first, more fundamental, issue is the significance of its being a consumption tax rather than an income tax. If the two systems are similarly progressive, is there any problem with ceasing to tax income? While noting several grounds on which one might reasonably argue for an income tax, I will aim to dispel several that I believe are misplaced. In particular, if one misunderstands the significance of exempting "capital income" and not taxing wealth until it is spent, one may erroneously conclude that a consumption tax cannot be adequately progressive after all. Consider a super-rich individual such as Bill Gates. Can a consumption tax really make him pay enough if his "capital income" is exempt and he never spends more than a small fraction of his vast wealth? In fact, exempting "capital income" has a much smaller effect than one might initially think on those such as Gates who build huge fortunes, and his wealth bears the consumption tax even before it is spent. Those criticisms therefore mean less than meets the eye, and less still if we compare a progressive consumption tax, such as the X-Tax, to a realization-based tax rather than a pure Haig-Simons income tax.

Edward P. Lazear and James M. Poterba, *Reforming Taxes to Promote Economic Growth,* 110 Tax Notes 387 (Jan. 23, 2006), 2006 TNT 15-30 (Jan. 24, 2006) (emphasis added):

Productivity growth depends on investment in human capital, physical capital, and intangible capital. Investment in human capital means acquiring skills through formal education and learning on the job. Investment in physical capital means adding to the stock of plant and equipment that makes workers more productive. Intangible capital includes the stock of research and development and other factors that make both physical and human capital more productive. Both proposals [of the President's Advisory Panel] encourage investment in skills by reducing marginal tax rates on labor supply for most earners. Both proposals encourage investment in physical and intangible capital by reducing the

tax wedge between the before-tax and the after-tax returns to new investments. Treasury estimates that moving from the current structure to the Growth and Investment Tax would lower the average tax burden on all investment from 17 percent to 6 percent. That would encourage new investment and could significantly increase productivity and wage growth.

In a global capital market, a nation's saving and its investment need not be equal, but they are linked. When a nation's saving is low, investment can remain high if the returns to investment attract foreign capital. Low tax rates on investment encourage foreign investment. But in the longer run, a nation's standard of living will grow more quickly if it owns the capital that raises its productivity, because it then benefits not only from the higher wage growth that results from using the capital, but also from the capital returns. The current U.S. tax system discourages saving. Both the proposed plans reduce the total tax burden on saving and investment, thereby promoting long-run economic growth.

COUNTERPOINT: LET'S NOT RUSH TO CHANGE THE SYSTEM

by Jasper L. Cummings, Jr., Washington, DC

The pro-consumption tax view has progressed from the theoretical to the possible in the course of the last 35 years. As George said to Coach Norman Dale in the 1986 movie *Hoosiers*: "Look, mister, there's... two kinds of dumb, uh ... guy that gets naked and runs out in the snow and barks at the moon, and, uh, guy who does the same thing in my living room. First one don't matter, the second one you're kinda forced to deal with."

Similarly, consumption tax proposals seem to have some political "legs," and we all sort of have to deal with them now. The President's Advisory Panel recently recommended a consumption tax alternative. "Common knowledge" now includes key elements of consumption taxation: (1) taxing capital discourages savings and investment, and that is bad; and (2) corporations don't pay taxes, people do, so we might as well not try to tax corporations.

The politically savvy say adoption of a consumption tax regime is highly unlikely in the near term. At most, some incremental shift toward the consumption end of the tax spectrum may occur, through things like bigger IRAs and more expensing of capital outlays. But even those changes likely will be influenced by the consumption tax arguments and by partial rejection of the theory of the income tax, which is that tax liability should relate to the current ability to pay, as measured by currently realized and recognized income. It is therefore imperative that we understand the consumption tax arguments. That can be difficult because (1) many of the arguments are "economic" in nature and somewhat unfamiliar to attorneys (and the economists seem to like it that way), and (2) some of the consumption tax proponents (other than the article authors quoted above) cannot be considered to be wholly objective.

I present my thoughts here not as an expert, but as an interested citizen who tries to be informed. This is all most of us can do, and it should be enough, because if political acceptance of consumption taxation occurs, it will be based on big picture choices. We should each see and understand those big picture choices clearly, for ourselves.

This is about who pays. "Dr. T.S. Adams … conclude[d] that 'modern taxation … is a group contest in which powerful interests vigorously endeavor to rid themselves of present or proposed tax burdens. It is, first of all, a hard game in which he who trusts wholly to economics, reason, and justice, will in the end retire beaten and disillusioned. Class politics is of the essence of taxation.'" Louis Eisenstein, THE IDEOLOGIES OF TAXATION 4-5 (Ronald Press 1961).

Not taxing capital income is not received wisdom. "The fairness of taxing more lightly incomes from wages, salaries and professional services than incomes from business or from investments is beyond question. In the first case, the income is uncertain and limited in duration; sickness or death destroys it and old age diminishes it. In the other, the source of the income continues; the income may be disposed of during a man's life and it descends to his heirs." Andrew W. Mellon, TAXATION: THE PEOPLE'S BUSINESS 56-57 (MacMillan 1924).

"Flat tax" is a stalking horse for consumption tax. Some have been enamored with the possibility of a "flat tax," presumably because the flat rate will be lower and the form will be shorter. Few realize that the term generally refers to a consumption tax at a flat rate. Admittedly, some versions of "flat taxes" are not flat (for example, the Bradford X-Tax), in that they tax wage income at progressive rates, while purportedly taxing business-level capital income at a flat rate. This would make sense to Mr. Mellon only if the wage rates scale down from the capital income rate so as to provide relief to wage earners.

Taxing capital later won't work. In the simplest version of a consumption tax, the tax is levied when the taxpayer spends money to consume. Suppose Mr. Jones earns $50,000 salary and consumes it all in the year and Mr. Big earns $500,000 in capital gains and consumes $50,000 in the year. Under a pure consumption tax, they both pay the same tax for the year. The theory is that Mr. Big will be taxed later, when he consumes the other $450,000. What if he dies with the $450,000 unspent? In theory, death should be the "final consumption" that balances the books on a consumption tax. But that concept does not appear in the models being offered, and most flat tax supporters would denounce it (although some scholars recognize its logic), just as they denounce the estate tax.

Corporations pay taxes. "Smart" folk like to amaze their friends and neighbors by smugly announcing that "corporations don't pay taxes," because they are intermediaries that can pass on their tax liabilities to employees, shareholders, customers, or some unknown combination of all three. While true, the observation does not prove that corporations should not pay taxes, or at least be a collection point for someone's taxes. It may provide support for integrating corporate and shareholder income taxation to avoid double taxation of the same income, but it does not support a shift to a consumption tax.

Corporations create wealth by using the benefits provided by the society and the various levels of government where they do business and are chartered: roads, peace, stable workforce, currency, etc. It is highly unlikely that the governments can determine which employees, customers, or owners are enjoying the benefits accorded the income producing business, much less tax them all. They may be anywhere in the world or may be tax-exempt.

Linking benefits with payment. We tend to forget that the prime basis for an income tax was the desirability of relating tax payments to the capacity of the taxpayer to pay at the time the tax is levied. A corollary is that the income tax is levied at the time the taxpayer enjoys the protection and other benefits provided by the government that presumably underwrote the production of the income to be taxed.

A consumption tax turns these connections on their heads. In some forms it focuses on divestment of funds at a time that may be far removed from the time of earning. The severance of taxing from earning and from the social conditions surrounding the time of earning could have profound effects on taxpayers' views of government. Might that be intended?

This is a moral issue. Prof. Ajay Mehrotra has written valuable studies of the work of Edwin R.A. Seligman and others in promoting the adoption of the income tax. *See* Ajay Mehrotra, *Edwin R.A.Seligman and the Beginnings of the U.S. Income Tax,* 109 TAX NOTES 933 (Nov. 14, 2005), 2005 TNT 219-43 (Nov. 15, 2005). His writings show how much public and political sentiment there was in favor of taxation on the basis of ability to pay, including the ability to pay from passive income. We should be embarrassed by the current lack of public debate about who should pay tax as a moral issue, relative to the debate at the turn of the century, particularly given the almost universal focus of the current debate on macroeconomic theory.

Savings and investment. We all must become little Greenspans. If the Fox News folk are going to say that savings and investment must be expanded at every second breath, we all need to know what that means.

Savings and investment are two different things. "Investment" refers to things such as Ford building new manufacturing plants in the U.S., and thus creating more domestic jobs and domestic economic activity. The theory is that Ford is not building those plants because there is not enough "savings" by other people, or because the "hurdle rate" that the plant must earn in profit is too high to attract debt or equity capital.

The desirability of more investment in the U.S. is real enough, but the talk about more savings gets fuzzy. The savings proponents generally want more savings by individuals. However, they conveniently ignore the second main way savings can occur in a country's economy: by the country's government avoiding dissavings. Annual deficits and the increasing national debt are forms of anti-saving that hurt Ford in the same ways as (and worse than) my not putting more cash into my 401(k) plan.

But even if we focus on 401(k) plans, the economic benefits are fuzzy. The theory is that the more individuals save, the more money is available for Ford to use to build that plant. This theory must be referring to borrowed capital, because statistics show that the vast majority of funds raised by U.S corporations is in the form of borrowing. But there is no shortage of U.S. dollars to borrow, at some price.

Therefore, the theory must be further refined to state that if Americans save more, domestic interest rates will decline, so Ford can afford to borrow more of our money and build more plants in the U.S. that otherwise would be uneconomic. These are some highly speculative assumptions on which to base a dramatic change in our tax system. We know there are all sorts of reasons why Ford may want to build plants abroad rather than here. Moreover, U.S. interest rates are not isolated from international money rates, and rates recently have been more affected by the Federal Reserve Bank's actions than by any amount of private savings or dissaving. It is not obvious how more savings by U.S. individuals is going to drive down U.S. bond rates. We should not adopt a consumption tax on such a "trust us, we know how economics works" argument.

Finally, two obvious, but little-discussed unintended consequence of increasing individual savings in the U.S. could drive interest rates up or have other bad results. First, saving individuals will buy fewer consumer goods, which will both put pressure on the profits of U.S. businesses and could cause imports to decline, thus reducing the need for foreigners to supply loans to the U.S. Conversely, if the increased "supply" of savings does make domestic interest rates fall, savers will earn less return on their savings, producing a zero sum game for them.

The truth comes out. Economists Edward Lazear and James Poterba (members of the President's Advisory Panel) have admitted the very constricted nature of the benefits of more savings, as quoted in the Point article above. They say the net gain to be had from more domestic savings comes down to this: "But in the longer run, a nation's standard of living will grow more quickly if it owns the capital that raises its productivity, because it then benefits not only from the higher wage growth that results from using the capital, but also from the capital returns." Lazear & Poterba, *supra.*

They are saying that the only net benefit to be had from more individual savings is that we individuals will own the return to the savings!!!! That is a substantial back-down from the more simplistic assertion that the additional savings will result in more domestic plant and equipment being built and bought (which they admit probably will happen anyway).

The buffalo hunt is over. An unspoken subtext of the push toward consumption taxes, is that even if the income tax has some moral claim, America can no longer "afford" the luxury of honoring it. The reason is that America faces a "perfect storm" of economic decline in (1) the end of the great 250-year buffalo hunt fostered by the rich vastness of this land, in-migration, stable government, and the relative absence of wars on our soil, etc., and (2) the end of U.S. dominance over the industrial revolution.

This is a fair point if the facts are right (U.S. is in new, dire, economic straits, and a tax change could ameliorate the problem). Are circumstances that dire? Are you that confident of the touted economic consequences? *Cf.* Jasper L. Cummings, Jr., *'Taxing Business Income Once': Where's The Beef? A Review and Critique of the Treasury Integration Study*, 54 TAX NOTES 1391 (Mar. 16, 1992). As observers begin focusing on the details, more and more of them are saying that substituting a consumption tax for an income tax, with "transition relief," produces relatively little, if any, long-term growth benefits. See Leonard E. Burman & William G. Gale, *The Tax Reform Proposals: Some Good Ideas, but Show Me the Money*, 110 TAX NOTES 397 (Jan. 23, 2006), 2006 TNT 15-33 (Jan. 24, 2006). And you can be sure that our Congress would give transition relief.

Taxing capital amounts to double taxing savings. This is a key premise of the consumption tax, because it does not tax capital income, except indirectly and partially under some models. The key cite for the premise is to John Stuart Mill's 1848 observation that a tax on income that is saved leads to a "double tax" on savings. John Stuart Mill, THE PRINCIPLES OF POLITICAL ECONOMY 317-318 (Colonial Press ed. 1899). This means that if I earn $100 and pay 3% tax and invest the $97 and pay 3% tax on annual interest received of 3% of $97, then the present value of the future taxes on the interest received in perpetuity will approximate another front-end tax of 3% on the $100 (or the $97). This results in a hypothetical approximate 6% tax on the $100.

Does that illustration intuitively make you want to not tax interest? This seems to be sort of like religion: either you believe it or you don't.

Somehow, that example has never shown me anything except an interesting mathematical truism (known as the E. Cary Brown principle): the present value of a tax on the future income to property is equivalent to a tax on the current value of the property at the same rate, holding all sorts of things constant that are never constant in the real world. See E. Cary Brown, *Business-Income Taxation and Investment Incentives, in Income, Employment and Public Policy: Essays in Honor of Alvin Hansen* (1948), *reprinted in* READINGS IN THE ECONOMICS OF TAXATION 525-37 (Richard A. Musgrave & Carl S. Shoup eds., 1959).

Conclusion. The Internal Revenue Code of 1986, as unfortunately amended since 1986, is unfair, unnecessarily hard to apply by normal folk, and not well suited to a populace that is frequently told by some of its leaders that government, taxes and tax collectors are bad. However, only a small part of that is the fault of an income tax. The blame can be widely shared by Congress, the Administrations (current and past), and the inherent greed of people (using here the Code definition of "person").

Rather than rejecting the income tax, we would do better to broaden the base and lower the rates along the lines of the Tax Reform Act of 1986, enhance our ability to collect the tax (as by withholding on various sorts of regular payments in addition to wages), and improve the people's view of government. The Bar should be at the forefront of those efforts. ■

CHALLENGE POINT:

SURVEYING THE SHOALS: **TAX HAZARDS LURK OFFSHORE**

by Thomas D. Greenaway, San Jose, CA[1]

INTRODUCTION: Last year we introduced this new feature—the Challenge Point—to highlight some of the excellent work done by members of the Young Lawyer's Forum who develop the problem that forms the basis of the Section's Law Student Tax Challenge Competition. This year the competition grew to include LLM students as well as JD students, and drew a record number of entries (see page 25 for a list of the winners). Tom Greenaway served as Co-Chair of the 2005 competition and in this piece he sets out some of the issues that challenged the competitors. His exposition provides a useful checklist of issues that arise in the increasingly common practice of transferring patents to offshore subsidiaries which may also be involved in developing intellectual property of their own.

–Alice G. Abreu, Philadelphia, PA

Interesting and complex tax issues arise when a U.S. corporation transfers existing patents to—and develops new patents in—a foreign entity. While transferring patents or other intangible property offshore may be a straightforward business decision, especially for a U.S. corporation regularly engaged in worldwide markets, the federal tax consequences of such transfers are complicated, owing to a panoply of provisions in the Code and attendant regulations designed to protect the revenue. This article surveys a few of the issues that lie beneath the surface.

THE **TRANSACTION**

Assume HavenCo, located in a fictional tax-advantaged foreign jurisdiction, has two shareholders: a U.S. pharmaceutical corporation, U.S.Co, and a British pharmaceutical firm, BritCo. In 1999, U.S.Co and BritCo created HavenCo by contributing property to the new corporation. In exchange, U.S.Co and BritCo each took back one-half of the common stock in HavenCo. BritCo contributed patents, and U.S.Co contributed cash. HavenCo used most of the cash received from U.S.Co to buy patents from U.S.Co at fair market value. HavenCo licensed these "legacy" patents to third party manufacturers, and HavenCo also developed new patents using research facilities in South Korea. By 2005, as the value of the legacy patents dwindled, almost all of HavenCo's revenue came from licensing new patents it developed.

THE **ANALYSIS**

FORMATION

Ordinarily, the formation of HavenCo would easily qualify for non-recognition under section 351, since U.S.Co and BritCo, together, transferred property to HavenCo in exchange for all the common stock in HavenCo. The answer here is not that simple, though, because certain transactions involving U.S. and foreign persons trigger section 367. In certain circumstances, section 367 denies the favorable treatment otherwise made available to those transactions under the organization and reorganization provisions of Subchapter C.

Generally, section 367(a) forces U.S. persons to recognize gain on transfers of appreciated property to a foreign corporation in exchange for stock in the foreign corporation. Furthermore, there are follow-on consequences for transactions subject to section 367, including basis adjustments and effects on earnings and profits. Since U.S.Co, a U.S. person, contributed property to HavenCo, a foreign corporation, solely in exchange for stock, section 367 was implicated when HavenCo was formed.

But the general rule of section 367(a) most likely does not apply in this case, since U.S.Co transferred only cash in exchange for HavenCo stock. Where, as here, the sole asset transferred to the foreign corporation is cash, section 367 does not require the transferor to recognize gain on the transaction, since the transferor realized no gain. Treas. Temp. Reg. §§ 1.367(a)-1T(b)(1), -(b)(3)(i); CMI Int'l, Inc. v. Commissioner, 113 T.C. 1, 6 (1999). *See* Rev. Rul. 68-43, 1968-1 C.B. 146. Furthermore, regulations limit the follow-on effects of section 367 to recognized gain. Treas. Temp. Reg. § 1.367(a)-1T(b)(4)(B). Where recognized gain would have been zero, section 367 has no subsequent effect on earnings and profits or basis. Nevertheless, U.S.Co had to report to the IRS the outbound transfer of its cash to HavenCo. I.R.C. § 6038B(a). Failure to report outbound transfers, on Form 926, can result in penalties and extends the statute of limitations on assessment. I.R.C. § 6501(c)(8); Treas. Reg. § 1.6038B-1(b)(1)(i); Treas. Temp. Reg. § 1.6038B-1T.

A question remains, however, whether U.S.Co's transfer of cash to HavenCo should be "stepped together" with HavenCo's subsequent cash purchase of U.S.Co's patents, under the step transaction doctrine. If the step transaction doctrine applies, U.S.Co will be treated as if it directly transferred the patents to HavenCo, and the circular flow of cash will be ignored. Therefore, U.S.Co would be subject to section 367(d) regarding intangibles—treating HavenCo's income attributable to the patents as current royalty payments to U.S.Co. *Cf., e.g.*, CCA 200610019 (March 10, 2006).

1 The analysis provided here reflects only the individual views of the author and does not represent the views held by the Internal Revenue Service or the Treasury Department.

But the assertion of the step transaction doctrine here may be fruitless. For one thing, since the effect of section 367 on future earnings and profits is contingent on the gain recognized under section 367, this issue has probably been laid to rest by the statute of limitations on assessment, assuming U.S.Co properly reported the outbound transfer of the cash to the Service. *See* I.R.C. §§ 6501(a), -(c)(8). Furthermore, HavenCo paid fair market value for the patents in 1999. It would be odd—to say the least—for the Service to assert the step transaction doctrine five years later in an attempt to *decrease* U.S.Co's gross receipts in 1999. Finally, since U.S.Co presumably paid more federal income taxes in 1999 than it would have if it had contributed the patents and not cash to HavenCo, all else being equal, the tax benefit rule has no place here, either. On the other hand, if the price HavenCo paid for the patents is not commensurate with the income they produce, the IRS—with the benefit of hindsight—may assert that section 367(d) applies.

Here, we avoid that problem by assuming HavenCo paid a price commensurate with income for U.S.Co's patents. By doing so, we also avoid another nearly-intractable problem in international tax: transfer pricing. A taxpayer's assertion of arm's length pricing may be subject to challenge by the IRS under section 482. Nevertheless, we assume the prices HavenCo paid for U.S.Co's patents were correct to avoid a detailed discussion of transfer pricing valuation principles—and the tricky question of whether section 482 would even apply to this case.

CONTROLLED FOREIGN CORPORATION

HavenCo is not a Controlled Foreign Corporation (CFC), since U.S.Co, the only U.S. shareholder, does not own more than fifty percent of the total combined voting power of all classes of stock or more than fifty percent of the total value of the stock. I.R.C. § 957(a). And that's good news for U.S.Co and HavenCo—CFCs are subject to some of the more onerous international tax provisions in the Code, found in Subpart F (sections 951 through 964). For instance, section 956, which taxes U.S. shareholders of CFCs on income from "U.S. property"—including the right to use patents in the United States, section 965(c)(1)(D)(i)—plays little, if any, role here.

PASSIVE FOREIGN INVESTMENT COMPANY

Even though HavenCo is not a CFC, it was probably a Passive Foreign Investment Company (PFIC), at least initially. PFICs include foreign corporations with mostly—75 percent or more—passive income or at least 50 percent passive assets. I.R.C. § 1297(a). Passive income includes royalty payments and patent fees. I.R.C. § 1297(b)(1), *incorporating* § 954(c). There is an exception, however, for rents and royalties derived in the active conduct of a trade or business, as long as those rents and royalties are not received from a related person. I.R.C. § 954(c)(2)(A). It is generally not good—at least from a U.S. shareholder's perspective—for a foreign corporation to be a PFIC. For example, "excess" distributions by PFICs to their U.S. shareholders, or dispositions of stock, subject the U.S. shareholder to taxation and interest charges that compensate the Treasury for deferral. I.R.C. §§ 1291(c)(1), -(f).

In the beginning, HavenCo probably was a PFIC, as almost all of its income came from royalties from U.S.Co and BritCo's "legacy" patents. In contrast, it is likely that HavenCo currently fits within the active trade or business exception, as: (1) almost all of the royalties HavenCo receives are derived from licensing patents it developed; (2) HavenCo is regularly engaged in the development of such patents; and (3) the royalties come from independent drug manufacturing plants, not U.S.Co or BritCo. *See* Treas. Reg. § 1.954-2(d)(1)(i). Nevertheless, whether an activity constitutes an active conduct of a trade or business depends on many different factors, and the case law is barren on the question of what that phrase means in section 954(c)(2)(A). *But see* Electronic Arts, Inc. v. Commissioner, 118 T.C. 226, 250-52 (2002) (holding that taxpayer's subsidiary engaged in "active conduct of a trade or business" in context of section 936 possessions tax credit), *distinguishing* Medchem (P.R.), Inc. v. Commissioner, 116 T.C. 308, 337 (opposite holding), *aff'd*, 295 F.3d 118 (1st Cir. 2002). It is probably essential that HavenCo employees manage the research in South Korea, and the fact that the research facilities are in South Korea—and not in the tax haven—may not hurt. *Cf.* Treas. Reg. § 1.954-2(b)(5)(i)(2).

Even though HavenCo may not be a PFIC now, it still may be subject to the taint of any prior PFIC status. Section 1297(b)(1) treats U.S.Co's HavenCo stock as PFIC stock if *at any time* during U.S.Co's holding period of the stock HavenCo was a PFIC. U.S.Co could purge the taint by making a special election, as long as the election is made within three years of the due date for U.S.Co's tax return for the year that included the last day HavenCo was a PFIC. Treas. Temp. Reg. § 1.1297-3T(b)(1).

CONCLUSION

U.S. corporations may transfer intangible property offshore to try to drive down their U.S. tax liabilities, but as this survey only begins to show, the federal tax consequences may not be certain. The prudent tax advisor will not rely solely on any single aid to navigation when working offshore. ■

POINTS TO **REMEMBER**

INTRODUCTION: The Points to Remember in this issue range from tax procedure to international tax and conclude with employee benefits. First, Leandra Lederman and Stephen Mazza explain when a taxpayer has a right to an administrative appeal. Nancy Beckner then illuminates the effects of newly proposed and final regulations on withholding obligations of partnerships with foreign partners. Back on the domestic front, new section 409A continues to confound, so Frank Tripodi explains how that provision applies in the case of severance payments.
–Alice G. Abreu, Philadelphia, PA

WHEN DOES THE TAXPAYER HAVE A **RIGHT TO AN IRS APPEAL?**

by Leandra Lederman, Bloomington, IN, and Stephen Mazza, Lawrence, KS

The Internal Revenue Manual provides that "[t]he Appeals mission is to resolve tax controversies, without litigation, on a basis which is fair and impartial to both the Government and the taxpayer and in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service." I.R.M. ¶ 8.1.1.1(2) (Feb. 1, 2003). As the recent decision in *Estate of Weiss v. Commissioner*, 90 T.C.M. (CCH) 566 (2005), T.C. Memo. 2005-284, suggests, taxpayers sometimes assert in deficiency cases that they have a substantive right to an Appeals conference, relying on regulations that provide:

> In any case in which the district director has issued a preliminary or "30-day letter" and the taxpayer requests Appeals consideration and files a written protest when required…against the proposed determination of tax liability, except as to those taxes described in paragraph (a)(3) of this section, the taxpayer has the right (and will be so advised by the district director) of administrative appeal to the Appeals organization.

Proc. Reg. § 601.106(b).

Case law, however, holds the regulations "directory and not mandatory in legal effect," Luhring v. Glotzbach, 304 F.2d 560, 565 (4th Cir. 1962); *see also* Rosenberg v. Comm'r, 450 F.2d 529, 533 (10th Cir. 1971). Thus, courts have held that IRS failure to provide a conference with Appeals is not a violation of due process, *Rosenberg, supra*, at 533; Cupp v. Comm'r, 65 T.C. 68, 83 (1975), *aff'd,* 559 F.2d 1207 (3d Cir. 1977) (unpublished table decision), and does not invalidate a notice of deficiency, *Luhring, supra*, at 563; Anderson v. Comm'r, 85 T.C.M. (CCH) 1187 (2003), T.C. Memo. 2003-112; Wisniewski v. Comm'r, 56 T.C.M. (CCH) 1227 (1989), T.C. Memo. 1989-60.

A taxpayer who ignores a 30-day letter usually will receive a notice of deficiency. If the notice of deficiency was not issued by Appeals and the taxpayer timely petitions the Tax Court, IRS Counsel typically will refer the case to the Appeals Office for "consideration of settlement" under Revenue Procedure 87-24, 1987-1 C.B. 720. *Estate of Weiss, supra,* points out that "once a taxpayer's case is docketed in the Tax Court, there is no provision in the procedural rules for a taxpayer to request an Appeals conference" (citing cases). Thus, although docketing the case in Tax Court will likely result in Appeals consideration of any case in which Appeals did not issue the notice of deficiency, petitioning the Tax Court will not give the taxpayer an opportunity to request an Appeals conference (unlike the opportunity generally afforded in a 30-day letter), much less give rise to a right to such a conference.

A case in Appeals on a "protest" basis (responding to a 30-day letter) is known as a "nondocketed" case. I.R.M. ¶ 8.1.1.4.2(2)(F) (Feb. 1, 2003). Requesting an Appeals conference in response to a 30-day letter is particularly important if the taxpayer will seek the recovery of litigation costs under section 7430. Section 7430(b)(1) provides that litigation costs cannot be awarded if the taxpayer did not "exhaust[] the administrative remedies available to such party within the Internal Revenue Service." Treasury regulation section 301.7430-1(b)(1)(i)-(ii) interprets that provision to require the taxpayer's participation in a nondocketed IRS Appeals conference, or, if no conference was granted, to have requested such a conference and filed a protest if necessary in order to obtain a conference. That regulation has been applied to preclude eligibility for section 7430 recoveries in some cases in which taxpayers did not participate in Appeals conferences. *See, e.g.,* Haas & Assocs. Accountancy Corp. v. Comm'r, 117 T.C. 48 (2001), *aff'd,* 55 Fed. Appx. 476 (9th Cir. 2003) (unpublished); Davis v. Comm'r, 90 T.C.M. (CCH) 166 (2005), T.C. Memo 2005-202.

Thus, in the deficiency context, an Appeals conference is not a right, but forgoing such a conference can adversely affect a future claim under section 7430. Could the IRS's failure to provide Appeals consideration nonetheless create some procedural advantage for the taxpayer? The petitioner in *Estate of Weiss* maintained that the IRS's failure to grant the estate an Appeals conference constituted grounds for shifting the burden of proof to the IRS. Section 7491 reallocates the burden of proof from the taxpayer to the IRS, but only if the taxpayer satisfies certain conditions and only in court proceedings arising from audits beginning after July 22, 1998. Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3001(a). Because of the effective date of the legislation, section 7491 did not apply to the estate's proceeding. Moreover, the Tax Court found that no other

authority supported a burden of proof shift in these circumstances.

Had section 7491 applied, would the IRS's failure to afford the taxpayer a nondocketed Appeals hearing, standing alone, have resulted in a shift in the burden of proof? Aside from a net worth limitation, which applies to partnerships, corporations, and trusts, the conditions that must be satisfied to cause the burden to shift represent affirmative obligations on the *taxpayer's* part. Among other requirements, the taxpayer must supply credible evidence supporting the taxpayer's factual assertions, satisfy applicable substantiation requirements, and cooperate with IRS requests for "witnesses, information, documents, meetings, and interviews." I.R.C. § 7491(a)(1), (2). The legislative history to section 7491 expands upon the cooperation requirement: "A necessary element of fully cooperating with the Secretary is that the taxpayer must exhaust his or her administrative remedies (including any appeal rights provided by the IRS)." H.R. Conf. Rep. No. 105-599, 105th Cong., 2d Sess. 239.

Thus, while a taxpayer seeking a burden shift under section 7491—much like a taxpayer seeking litigation costs under section 7430—is compelled to have participated in Appeals consideration, if available, nothing in the burden of proof shift rules appears to establish an obligation on the IRS's part to provide taxpayers in deficiency cases with access to administrative settlement procedures. The statute merely requires that the IRS's requests for information and access be "reasonable;" it does not establish conditions under which those requests must be made. I.R.C. § 7491(a)(2)(B).

In contrast with deficiency cases, a taxpayer who is the subject of a federal tax lien or levy proceeding has the affirmative right to request an Appeals hearing as part of the Collection Due Process (CDP) procedures. I.R.C. §§ 6320(b)(1) (CDP appeal rights triggered by notice of federal tax lien); 6330(b)(1) (CDP appeal rights available prior to levy). Unless the taxpayer failed to receive a notice of deficiency or did not otherwise have an opportunity to challenge the underlying tax liability, the taxpayer may not dispute the existence or amount of the asserted liability during the CDP hearing. I.R.C. § 6330(c)(2)(B). *Cf.* Montgomery v. Comm'r, 122 T.C. 1 (2004) (holding that taxpayers who had not been sent notice of deficiency could challenge amount of self-reported liability). The taxpayer may raise spousal defenses and discuss collection alternatives during the CDP hearing. *See* Treas. Reg. § 301.6320-1. The taxpayer also has the right to obtain judicial review of the Appeals Officer's determination. I.R.C. § 6330(d).

Since the CDP process was established in 1998, the IRS and the courts have struggled to establish the precise rules for requesting and conducting CDP hearings. *See, e.g.,* Keene v. Comm'r, 121 T.C. 8 (2003) (reviewed by the court) (Tax Court decision finding taxpayer entitled to audio record a CDP hearing despite previously issued Treasury Regulations); Nestor v. Comm'r, 118 T.C. 162 (2002) (reviewed by the court) (Tax Court considered but did not decide whether taxpayer was entitled to a copy of his transcript of account from Appeals officer). Nonetheless, if the taxpayer properly requests Appeals consideration as part of the CDP process, some form of Appeals consideration usually must occur. Treas. Reg. § 301.6330-1(d)(1). *But see* Lunsford v. Comm'r, 117 T.C. 183 (2001) (reviewed by the court) (Tax Court refused to remand the case for a CDP hearing and decided case on the record before it); Chief Counsel Notice CC-2003-031 (Sept. 11, 2003) (taxpayer not entitled to face-to-face CDP hearing if taxpayer intends to raise only frivolous arguments).

Thus, generally a taxpayer who receives a 30-day letter has the opportunity to request Appeals consideration as part of a deficiency case, and may wish to do so to protect procedural opportunities under sections 7430 and 7491. A taxpayer who petitions the Tax Court in response to a 90-day letter may also end up negotiating with Appeals but lacks a formal opportunity to request an Appeals conference. The deficiency context contrasts with collection cases, in which the taxpayer, having received a lien or levy notice, has the affirmative right to request Appeals consideration. The *Estate of Weiss* case confirms that, outside the CDP context, there is no substantive right to an Appeals conference.

LIMITED RELIEF FROM OVER-WITHHOLDING FOR PARTNERSHIPS AND THEIR FOREIGN PARTNERS: NEW SECTION 1446 REGULATIONS

by Nancy Beckner, Newville, PA

A previous Point that appeared in the Fall 2003 issue of this NewsQuarterly briefly described section 1446 withholding and what were then newly proposed section 1446 withholding regulations (the "2003 Proposed Regulations"), as part of a broader discussion of the use of partnerships by inbound foreign investors. Treasury has now published final section 1446 regulations (Treas. Reg. §§ 1.1446-1 through -5 [the "Final Regulations"]), and temporary and proposed regulations (Temp. Reg. §1.1446-6T and Prop. Reg. §1.1446-6 [collectively, the "Temporary Regulations"]). These regulations (T.D. 9200, 70 Fed. Reg. 28702, May 18, 2005) are generally effective for partnership taxable years beginning after May 18, 2005, but a partnership may elect to have them apply to partnership taxable years beginning after December 31, 2004. The preamble (the "Preamble") includes an extensive description of both the Final and Temporary Regulations.

OVERVIEW OF SECTION 1446 REGIME

Section 1446 requires partnerships having foreign partners to withhold U.S. income tax with respect to each foreign partner's allocable share of

partnership effectively connected taxable income ("ECTI"). Tax must be withheld even if the partnership makes no distributions, and the partnership is required to pay estimated section 1446 tax in installments during the partnership's taxable year. (A different rule applies to publicly traded partnerships having effectively connected gross income; such partnerships pay the section 1446 tax by withholding on distributions to foreign partners under Reg. §1.1446-4.) Tax must be withheld at the highest applicable rate (the section 1 rate for non-corporate partners and the section 11 rate for corporate partners); however, under the Final Regulations, the partnership may be able to consider preferential rates applicable to long-term capital gains or other special items of partnership income or gain. (Reg. §1.1446-3(a)(2)(ii)). A foreign partner takes the withheld tax into account in determining estimated tax and also credits it against such partner's actual tax liability for the year with respect to effectively connected income, claiming a refund if the withheld tax exceeds the actual tax due.

The section 1446 withholding regime can result in tax being withheld in excess of a foreign partner's actual tax liability because, with limited exceptions under the Temporary Regulations, a partnership cannot take into account its foreign partners' effectively connected losses from non-partnership activities or such partners' loss carryovers in determining the amount of section 1446 tax, and current year partner-level items cannot be taken into account. Also, because the requirement to pay installments of section 1446 tax is not dependent on the partnership having cash available for distribution to foreign partners, from which the tax can be withheld, the withholding requirement can place a burden on non-foreign partners, particularly in partnerships that have cancellation of indebtedness ("COD") income. The Final and Temporary Regulations do not resolve either of these problems, except to the limited extent the certification procedures of the Temporary Regulations may reduce a partnership's section 1446 tax obligation with respect to certain foreign partners. Drafters of partnership agreements should, therefore, continue to consider mechanisms to address the possibility that section 1446 withholding tax could exceed foreign partners' shares of distributable cash and could have an adverse economic affect on other partners. For further discussion of issues posed by the May 18, 2005 proposed regulations, *see* letter of Nov. 4, 2005, submitted by the Section. Michael J. Karlin and Alan I. Appel had principal responsibility for preparing those comments, which raised concerns relating to both the Proposed/Temporary Regulations and the Final Regulations and recommended several changes. *ABA Tax Section Comments on Proposed Regs on Partnership Withholding*, 2005 TNT 215-11 (November 8, 2005).

FINAL REGULATIONS

The Final Regulations modify and clarify the 2003 Proposed Regulations in several ways, including the following: (1) they more closely align section 1446 documentation requirements with the section 1441 withholding regime, including use of Forms W-8ECI and W-8EXP (Reg. §1.1446-1); (2) they clarify certain documentation questions involving tiered partnerships; (3) they clarify that, if a foreign tax exempt organization is a partner, section 1446 withholding applies only to the partner's allocable share of ECTI which is includable in the partner's calculation of unrelated business taxable income under section 512 (Reg. §1.1446-3(c)(3)); (4) they address several tax calculation, payment and reporting matters (Reg. §1.1446-3), including: retention of the rule that section 1446 trumps section 1445 withholding with respect to dispositions of U.S. real property interests, retention (with two exceptions) of the 2003 Proposed Regulation's partner notification requirements, treatment of a partnership's payment of withholding tax installments as "advances or drawings," introduction of a rule permitting section 1446 withholding at preferential rates for long-term capital gains and certain other items, and modification of the deemed filing and payment rules which can affect additions to tax, interest and penalties for noncompliance with section 1446; and (5) they provide special rules for tiered trust or estate structures, clarify certain notice provisions involving publicly traded partnerships, eliminate a publicly traded partnership's ability to elect withholding based on shares of ECTI rather than distributions and address certain "look through" rules for tiered partnership structures.

Notwithstanding comments to the contrary suggesting other approaches, the Final Regulations do not offer any exception with respect to foreign partners' allocable shares of partnership COD income and gain from foreclosures, with section 1446 tax ameliorated only to the extent available using the certification procedures of the Temporary Regulations (see Part B. of the Preamble).

SOME PROVISIONS OF SPECIAL INTEREST

1. Use of Preferential Rates. In determining the rate of section 1446 tax, a partnership may now consider the type of income or gain applicable to a foreign partner and the preferential rates applicable to such income, rather than using the highest section 1 or section 11 rates otherwise mandated. Thus, for example, for long-term capital gains allocable to a non-corporate foreign partner, the partnership can pay section 1446 tax at the highest capital gains rate. However, a partnership cannot use a preferential rate where the rate depends upon the corporate or non-corporate status of a partner and such status has not been established by documentation or the regulations otherwise direct the partnership to use the highest applicable section 1446(b) rates.

2. Deemed Cash Distributions under Section 1446(d). When a partnership pays section 1446 tax with respect to a partner, the payment is

generally deemed to be a distribution to the partner. To reduce the likelihood that installment payments during the year, if treated as distributions, will trigger gain recognition under sections 731 and 741, the Final Regulations treat the deemed distribution as an advance or drawing (within the meaning of section 1.731-1(a)(1)(ii)) against the partner's distributive share of partnership income. Consequently, the ramifications of the partnership's payment of section 1446 tax will generally be considered by the partner at the end of partnership's taxable year. This special rule does not affect the date the partnership (or partner) is considered to have paid the tax for purposes of section 6654 and section 6655 failures to pay estimated tax.

3. Refunds. Non-publicly traded partnerships may obtain refunds for section 1446 taxes paid to the extent that the amounts are not reflected on a Form 8805 issued to a partner. Publicly traded partnerships (which pay tax based on distributions) are still subject to the refund provisions of section 1464 and its regulations.

4. Additions to Tax, Interest and Penalties. Part C.6 of the Preamble addresses additions to tax, interest and penalty matters, and Treas. Reg. §1.1446-3(e)(4) offers several important examples of how these provisions function. The following provisions are of special interest:

(i) Effect on Partnership of Partner Estimated Tax Payments. If a partnership fails to file and pay its section 1446 tax, a partner's payment of estimated tax will not provide the partnership with any benefit with respect to the partnership's computation of underpayment additions to tax under section 6655; the partnership is deemed to have paid the tax only when the partner has paid the tax, with such payment being credited to the partnership's account on the later of the date the tax is considered paid by the partner for purposes of sections 6511(b)(2), (c) and 6512 or the last date for paying the section 1446 tax without extensions.

(ii) Elimination of Deemed Filing Rule. The partnership "deemed filing" rule is eliminated. Thus, a partnership will not be "deemed" to have filed Forms 8804 or 8805 at any time, and once the failure to file penalty under section 6651(a)(1) begins to accrue, a partnership may affirmatively stop the accrual only by filing Form 8804. In other words, if a partnership fails to file Form 8804 and section 1446 tax has not been paid (or deemed paid) by the prescribed payment date, the failure to file penalty begins to accrue and can only be stopped by filing or when the statutory limit of the penalty has been reached.

TEMPORARY REGULATIONS

In a departure from the 2003 Proposed Regulations, the Temporary Regulations permit a partnership to adjust its section 1446 tax to consider a foreign partner's deductions and losses that are reasonably expected to be available to reduce the partner's U.S. income tax liability on the partner's share of ECTI from the partnership. Certain foreign partners may certify deductions and losses to the partnership to reduce section 1446 tax, but a certification will only be effective for the partnership year for which it is submitted. Before each installment date or Form 8804 filing date, the partnership will then consider whether the procedures in the Temporary Regulations apply. A partnership is not obligated to consider a partner's certified deductions or losses or may consider only a portion of such certified amounts.

A partner may submit a certificate only if the partner has met the Reg. §1.1446-1 documentation requirements and can represent either that he timely filed, or will timely file, a U.S. income tax return for each of the preceding four years and for the partner's taxable year for which the certificate is considered. The partner must also make certain representations regarding timely payment of tax. Generally foreign trusts and estates are not permitted to use the certification procedure, except for certain grantor trusts when the grantor meets the documentation and other requirements of the Temporary Regulations. There are also limitations and special procedures for tiered partnerships.

A foreign partner can only certify deductions and losses that are or will be reflected on the partner's U.S. return filed for a taxable year ending prior to the installment due date (or Form 8804 filing date) for the partnership taxable year for which the certificate is considered. A partner may also certify a loss that was set forth on a Form K-1 from the partnership in a prior year but was not reflected on a prior year return's because it was suspended under section 704(d). The partnership may not consider certified net operating loss deductions in excess of 90% of the partner's allocable share of ECTI.

A partnership is generally not relieved from liability for section 1446 tax (or penalties and interest) if the partnership or the IRS determines a partner's certificate is defective or is updated and the section 1446 tax increases. If the partnership has reasonably relied on the certificate, it should not be subject to the section 6655 additions to tax. The Temporary Regulations provide several examples of the effect on a partnership when a partner's certificate is found defective. Counsel and other partnership advisors should analyze carefully the certification procedures and ascertain the level of risk the partnership assumes if it takes into account such certificates in determining the partnership's section 1446 withholding tax. The certification process may also raise additional conflict of interest issues among partners and between certain partners and the partnership.

CONCLUSION

The foregoing discussion is intended to highlight some of the more important features of the Final and Temporary section 1446 Regulations and to identify a few of the concerns which partnerships and partners may encounter under the section 1446 withholding tax regime.

NAVIGATING **SEVERANCE ARRANGEMENTS** IN THE SECTION 409A SEA CHANGE

by Frank Tripodi, New York, NY

Section 409A of the Internal Revenue Code (the "Code"), and the subsequently issued proposed regulations, 70 Fed. Reg. 57930 (Oct. 4, 2005), establish an entirely new regime to address the operation of nonqualified plans that provide for the deferral of compensation. Previous Points in this NewsQuarterly have discussed various aspects of the changes wrought by the enactment of section 409A. *See, e.g.,* David Pratt, *The Not-So-Brave New World of Deferred Compensation*, Sec. Tax'n News-Quarterly, Fall 2005 at 8. This Point will address the implication of section 409A for severance arrangements.

Under the new regime, typical severance arrangements are treated as plans that provide for the deferral of compensation, even though few would have considered such arrangements to be deferred compensation prior to the enactment of section 409A. Thus, both severance compensation under broad based severance plans and individual severance arrangements must be tested to determine compliance with section 409A. A failure to do so may expose participants in such arrangements to the 20% tax and interest provisions of section 409A.

EXCEPTIONS TO THE APPLICATION OF SECTION 409A

Severance arrangements, as well as deferred compensation generally earned and vested prior to January 1, 2005 are grandfathered and not subject to section 409A, provided that such arrangements are not materially modified after October 3, 2004. In order to be earned and vested, the compensation must not be subject "to either a substantial risk of forfeiture (as defined in [Treas. Reg.] §1.83-3(c)) or a requirement to perform further services." Notice 2005-1, Q&A #16. Unfortunately, as virtually all severance arrangements require continued service by the employee until actual termination, few, if any, severance arrangements with current employees would be considered earned and vested prior to the date on which an employment relationship terminates. Therefore, virtually any existing severance arrangement with a current employee will not fit into this exception. Of course, payments made under severance arrangements which were earned and vested prior to January 1, 2005 (where, for example, an employee terminated employment prior to this date) will continue to remain subject only to prior law and will avoid taxation under section 409A.

For currently existing severance arrangements, one of two broad based exceptions from the application of section 409A may be available. First, any severance arrangement that is payable upon an involuntary separation from service (or which is part of a window program) and that is collectively bargained under an arms-length negotiation will not be considered to provide a deferral of compensation. Prop. Reg. §1.409A-1(b)(9)(ii). Second, an exception from deferral of compensation also exists for employees who are not parties to a collectively bargained agreement. To qualify for this exception, payments upon the involuntary separation from service (or under a window program) under these types of arrangements must not exceed the lesser of: (a) two times the employee's annual compensation in the calendar year prior to the year of the separation from service or (b) two times the maximum limit on annual compensation under qualified plans under section 401(a)(17) for such year (this limit is $210,000 in 2005 and $220,000 in 2006). Prop. Reg. §1.409A-1(b)(9)(iii)(A). Additionally, to use this exemption from section 409A, all payments must be fully made by the end of the second calendar year after the year in which the separation from service occurs. Prop. Reg. §1.409A-1(b)(9)(iii)(B). These exceptions allow many involuntary separation arrangements for rank and file employees, and even for some executives, to remain unaffected by section 409A.

Under yet another exception, the short-term deferral exception, severance pay will not be considered deferred compensation if at all times all severance payments will be made within 2½ months after the end of the later of the employer's or employee's fiscal year in which the severance payments were no longer subject to a substantial risk of forfeiture. Prop. Reg. §1.409A-1(b)(4). Thus, severance payments under an involuntary separation arrangement made in a lump sum or over a short period (up to 14½ months depending on the date the employee terminates) would not be subject to section 409A.

ISSUES WITH GOOD REASON

Unfortunately, language in the Preamble to the section 409A proposed regulations raises significant concerns about the application of the short-term deferral exception. The Preamble leaves open the question whether the inclusion of a provision for constructive termination or for termination for "good reason" would result in the severance arrangement no longer being subject to a substantial risk of forfeiture. According to the Preamble, "the Treasury Department and the IRS are not confident that amounts payable upon a voluntary separation from service, and amounts payable only upon a termination of services for good reason, always may be adequately distinguished. . . . Accordingly, the regulations do not treat the right to a payment upon a separation from service for good reason categorically as a right subject to a substantial risk of forfeiture." 70 Fed. Reg. 57941. Many employment contracts include a good reason termination provision on the theory that an employer should not be able to force the employee to resign by materially altering aspects of an employment arrangement to avoid paying the con-

tractually agreed severance. Under the Service's current interpretation, the inclusion of such constructive termination provision to protect the employee may lead any such severance arrangement not only to be classified as free from a substantial risk of forfeiture, but also to fail to qualify as an involuntary separation agreement.

The position taken in the Preamble has two consequences. First, commencing with the date that the arrangement is executed, the payments will not be considered to be subject to a substantial risk of forfeiture. Thus, the short-term deferral rule will not be applicable and the deferred amounts must then comply with section 409A. For severance arrangements, the most troublesome issue in complying with section 409A arises with respect to specified employees of public companies (as defined in section 416(i) without regard to paragraph (5)). Section 409A provides that payments made to a specified employee of a publicly traded corporation upon a separation from service must be delayed for at least six months following that separation. I.R.C. § 409A(a)(2)(B)(i). If the short-term deferral exception applied, payments to a specified employee could be made immediately in lump sum (or in installments that would otherwise comply with the short-term deferral exception); however, if the specified employee's severance arrangement includes a good reason termination provision, then, under the Service's current interpretation, the employee may not be able to receive payments during the six-month waiting period. This remains the case even if the employee does not exercise the good reason provision and is actually terminated without cause by the employer (provided that the employee would receive the same or greater payments upon a good reason termination as the employee would receive upon a termination without cause).

Second, the arrangement might no longer be considered solely an involuntary separation arrangement. Because section 409A imposes a tax at the plan level, a violation of section 409A in a single plan in a category of deferred compensation will cause all plans in the same category to become subject to the penalty and interest provisions of section 409A. There are four categories of plans for deferred compensation: account balance plans, non-account balance plans (such as defined benefit retirement plans), involuntary separation plans and all other plans (including equity awards governed by section 409A). Prop. Reg. §1.409A-1(c)(2). Thus, if a severance contract with a good reason provision is simultaneously an involuntary separation arrangement and also an "other" plan, and if such contract were to fail to comply with section 409A, then all severance arrangements as well as all plans in the other category could be immediately subject to the penalty and interest provisions of section 409A.

Finally, the Service's position regarding good reason provisions is inconsistent even within section 409A. The preamble notes that payments upon a purely voluntary separation from service may not always be adequately distinguished from true constructive terminations; therefore the inclusion of a good reason provision may be tantamount to the absence of a substantial risk of forfeiture. However, when addressing grandfathered arrangements, the inclusion of the same good reason provision does not make the benefits under an arrangement earned and vested. Given this double standard, planners must carefully consider the Service's position on good reason provisions.

COMPLYING WITH SECTION 409A

Complying with section 409A generally means ensuring that payments deferred under the severance arrangement follow the election and distribution rules under the Code. The initial election to defer compensation must generally be made on or before the end of the fiscal year immediately preceding the first fiscal year in which the services relating to the compensation are first performed. I.R.C. § 409A(a)(4). Under separation agreements negotiated around the time of the employee's termination, it seemed that no valid election could be timely made, as the compensation payable would arguably have related to services performed either in the current year or even in prior years. Fortunately, the Service has in the proposed regulations provided that the initial election for involuntary separation arrangements (as stated above, this would apparently not currently include arrangements where a good reason termination was applicable) may be made up to the time the employee has a binding right to the payment, provided that such severance compensation is the subject of an arm's length negotiation. Prop. Reg. §1.409A-2(a)(9).

Although section 409A requires that distributions generally be made under a fixed schedule, severance plans raise special issues. Although payments under a compliant plan may generally be spread over any fixed period of time agreed to by the parties, certain items of severance must be restricted to a limited payment period to comply with section 409A. For example, reimbursement arrangements generally do not comply with the distribution rules under section 409A. However, some reimbursement arrangements, such as moving expenses or reimbursements of medical coverage under a discriminatory health plan, will be exempt from section 409A provided that reimbursements for taxable amounts expire by the end of the second taxable year following the year of the termination of service. Prop. Reg. §1.409A-1(b)(9)(iv). These types of reimbursement arrangements are exempt regardless of whether the termination was involuntary or voluntary, i.e., under a severance arrangement providing for good reason. Also, as discussed above, distributions of deferred compensation under a section 409A compliant plan to a specified employee on account of a termination of severance must not commence until

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2006 PRO BONO AWARD RECIPIENT: JANET SPRAGENS

by Leslie Book, Villanova, PA[1]

JANET SPRAGENS

INTRODUCTION: Each year, the Tax Section presents its Pro Bono Award to a member who has demonstrated leadership in pro bono representation and a true commitment to serving low income taxpayers. This year's award was presented to Professor Janet Spragens at the Section's 2006 Midyear Meeting in San Diego. Because Janet was unable to attend, Professor Leslie Book accepted the award in San Diego on her behalf and delivered the following remarks. It is with deep sorrow that we report that Professor Spragens passed away on February 19, 2006.

It is truly an honor for me to stand here today to accept the Tax Section's pro bono award on behalf of my friend and colleague, Janet Spragens.

Janet is a pioneer; she is a woman whose work touches and will continue to touch thousands of people in ways that are both far-reaching and immediate. Janet is the rare academic who not only criticizes, but who offers solutions. She is among an even rarer group who not only offers solutions but who has the wherewithal, persistence and skills to help Congress legislate and the IRS implement those solutions. In particular, Janet is widely acknowledged, along with Nina Olson and a few others, as being the driving force behind getting low income taxpayer clinics out of a handful of law school basements and into the mainstream of public interest legal work. Janet's efforts led to the passage of the low income taxpayer clinic (LITC) funding legislation in the 98 IRS Restructuring and Reform Act. As her colleague at American University Nancy Abramowitz recounts:

"In the mid-90's when testifying before the IRS restructuring commission about the issues facing the population of working poor on the tax rolls, Janet was asked what could be done. She said, somewhat off handedly, just provide funds to create more clinics for the provision of services to this needy population across the country."

RRA 98 contained a matching funding provision for clinics, which has become the genesis of low income taxpayer clinics, and Janet's behind and in front of the scenes efforts with many were ***an*** and perhaps ***the*** instrumental reason for federal funding of low income taxpayer clinics.

When Janet testified before the Restructuring Commission about the need for tax clinics, there were maybe a dozen scattered clinics around the country—today there are over 150 tax clinics, representing many thousands of low income taxpayers—taxpayers who before LITC funding literally had nowhere to go for legal assistance.

Writing a few years ago in the book *Tipping Point*, author Malcolm Gladwell claims that ideas spread and gain traction when those ideas are championed by "people with a rare set of social gifts." The types of gifts needed to promote ideas are housed in people he describes as *connectors, mavens*, and *salesmen*. *Connectors* are the people who have special talents for bringing people, often from different, but important, worlds, together. *Mavens*, from the Yiddish, are people who have accumulated lots of knowledge. *Salesmen* are those people whose force of personality or charisma helps ensure ideas are accepted by others.

Janet is all three of these types of person rolled into one, and the tax system has been the better for it. Janet bridges economists, legislators, staffers, the private bar, lobbyists, and, perhaps most importantly, the common taxpayer often caught in the compliance crosshairs. Janet knows her way around the law, and had the insight that with last decade's welfare reform and the shift of many benefits to delivery within the tax code, legal representation before the IRS or in Tax Court would be crucial for the working poor. This point is accepted now, but ten years ago, the notion that people might need free legal representation in tax matters was radical. And those who work with Janet know her ability to persuade, accomplished not through bluster, but through force of argument, grace, and persistence, and an occasional well-timed icy silence.

If all Janet did was ensure federal funding of clinics, her status as a founding mother of LITCs alone would warrant the recognition that the Tax Section provides this morning. She has done so much more.

As her colleague Nancy Abramowitz notes, Janet is the long-standing "go to" person on low income tax issues—for students, for colleagues, for legislators, for regulators, for economists, for educators, for all. She is also a key contributor to the

1 I am grateful for the assistance of Janet's longtime colleague, Nancy Abramowitz, in preparing this speech.

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tax community at large on all matters of income tax concern. She has undertaken active leadership roles in the ABA Tax Section ATPI, and was a co-founder and director of the Theodore Tannenwald, Jr. Foundation for Excellence in Tax Scholarship. She has played a key role in training new clinicians through the organization and hosting jointly with the ABA of six annual clinical workshops open to new and experienced clinicians. She has taught hundreds of students and represented countless low income taxpayers at AU's Federal Tax Clinic, one of the oldest tax clinics in the country. Her testimony over the last few years before the IRS Oversight Board is remarkable for its insights into the unique challenges that modernization creates for low income taxpayers. Janet is easily recognized as a key creator, educator, mentor, and cheerleader for the community of tax clinicians that exists today.

Many of us are saddened that Janet's health prevents her from joining us today to receive this award in person. Yet Janet is in this room. Janet is here—that the Tax Section recognizes in this manner our members' pro bono work reflects Janet's presence. Likewise, Janet's presence reaches and will continue to do so. She sits at counsel's table when the S session of the Tax Court is in town. Janet is there when a low wage worker's EIC is frozen without process, and a legal aid attorney, a volunteer or student lawyer challenges the IRS' actions.

Her work is an inspiration, and a reminder to us all of our obligations to work for the public good, in many forms and with much impact. For these reasons, I am so honored to stand before many of Janet's friends and accept this award on her behalf. ■

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Atlanta, Georgia
June 22, 2006

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Prof. Howard Abrams, Emory Law School, Atlanta, GA
Susan Kalus, Sutherland, Asbill & Brennan LLP, Atlanta, GA

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SPOTLIGHT ON COMMITTEES: DIVERSITY

by Walter W. Burford, Washington, DC

This is an exciting time for the Diversity Committee. As a result of our newly customized Committee strategy, the efforts of the Committee's leadership team, and the partnerships we have undertaken within and outside of the Section, we have increased our membership by more than 40% in the first six months of this fiscal year. The Committee also cosponsored a Midyear program profiling Section leaders who are minorities, women, or both, and has taken the lead in brokering a partnership between the Tax Section and the Real Property, Probate and Trust Section (RPPT) to conduct a CLE program designed to attract members of various ethnic bar associations.

The Committee seeks to foster diversity within the Section by seeking the active involvement by tax lawyers of color, women lawyers, lawyers with disabilities, lawyers from diverse ethnic backgrounds and lawyers of diverse sexual orientation. During May of 2005, we devise a new strategy that would help us achieve some necessary interim goals. We therefore created Subcommittees with the following leadership: Advisory Committee (Glenn Carrington, Chair); Programming (Craig Boise, Chair); Committee Partnerships (Gerald Thomas and Maria Murphy, Co-Chairs); Membership and Development (Alex Perez, Chair); and Public Relations (Kristin Jones, Chair).

The Committee's new strategy, spearheaded by the new Subcommittees, focuses on: 1) working with the Section leadership and senior level tax practitioners to achieve greater diversity within the Section; 2) identifying programming that encourages participation by a diverse audience; 3) identifying opportunities to work with other committees and organizations; 4) recruiting members of diverse backgrounds, and evaluating the success of our strategies for meeting the needs of these members; and 5) creating greater awareness of the Committee's activities.

The Committee has recently worked on various projects and continues to work on new projects and activities. Recently, the Committee co-sponsored a two-part program on the intersection of race and tax. Part I included Prof. David Brennen, Prof. Beverly Moran, Prof. Janet Thompson Jackson, and Mildeen Worrell (House Ways & Means Committee staff lawyer), and Part II included Prof. Karen Brown, Prof. Dorothy Brown, and Mylinh Uy (practicing attorney). The panelists addressed the impact on minorities of rules regarding tax-exempt organizations, social security, taxation of the marital unit, economic development (such as the New Markets Tax Credit), the treatment of the costs of home ownership, and whether any possible connections exist between race and the legislative process. Thus, the content of the panel discussions focused on the intersection of tax policy and race and brought an emerging genre of scholarship, sometimes referred to as critical tax, to the Section. Both parts of the program were enthusiastically received.

During the Section Midyear meeting in February of this year, the Committee co-sponsored a program entitled, "Profiles in Diversity," which featured a number of section leaders, including Glenn Carrington (Council Member), Reginald Clark (Chair, Corporate Tax Committee) and Susan Serota (Tax Section Chair-Elect), who shared their experiences and provided concrete steps interested members could take to rise to leadership positions in the Section, as well as within their respective areas of tax practice.

The Committee also has represented the Section in discussions with RPPT's Community Outreach Committee. That committee provides continuing legal education training that is designed to attract members of various ethnic bar associations. The Section has approved a proposal to work with RPPT on this important CLE program and we expect that the Section and RPPT will soon begin to undertake this effort.

As indicated by the few examples of the Committee's activities discussed above, the Committee is making significant progress in achieving its mission. However, we need to continue to increase the number of people within the Section who would like to assist in supporting the Committee's efforts. There are countless ways Section members can assist, including actively seeking diversity in your panel discussions, committee activities, networking, and mentoring.

To obtain more information about the Diversity Committee including contact information for the officers, go to the committee's webpage at www.abanet.org/tax. ■

NEWS BRIEFS

SECTION TO VOTE ON BYLAW CHANGES AND MODEL STATE TAX TRIBUNAL ACT

Pursuant to Article VIII, Section 8.4 of the Bylaws of the Section of Taxation, this message serves as notice to the Section that proposed changes to its Bylaws will be submitted to the ABA Board of Governors for approval contingent upon approval by the members of the Section at the 2006 May Meeting Plenary Session. The revised Bylaws are available for review on the Section's website at: http://www.abanet.org/tax/mo/premium-tx/sectionvote/sectionbylaws.pdf.

The Council of the Section of Taxation has approved a Model State Administrative Tax Tribunal Act, which will be submitted for consideration by the ABA House of Delegates at the 2006 Annual Meeting contingent upon approval of the members of the Section at its 2006 May Meeting Plenary Session. To review the full report with recommendations, which was prepared by members of the State and Local Taxes Committee, please visit the Section's website at: http://www.abanet.org/tax/mo/premium-tx/sectionvote/mstta.pdf.

MIDYEAR MEETING TAPES AND CDS AVAILABLE

Tapes and CDs of the 2006 Midyear Meeting programs are now available from Digital Conference Providers, the Section's new audio vendor. Orders can be placed through their website at: https://www.dcporder.com/abatx/ or by calling: 1-630-985-1182.

IRS TO HOST SIX TAX FORUMS THIS YEAR

As a component of the Internal Revenue Service's communication and outreach efforts, the IRS will host a series of tax forums across the nation this summer for the benefit of tax professionals. The forums present the latest news and information from the IRS over three days of seminars. Representatives of the IRS, the American Bar Association Section of Taxation, and other organizations will lead seminars and be available for discussion.

The locations and dates of the 2006 tax forums are:

- Anaheim, Calif. — June 27-29
- Chicago, Ill. — July 11-13
- Atlanta, Ga. — July 25-27
- Orlando, Fla. — Aug. 1-3
- Las Vegas, Nev. — Aug. 22-24
- New York, N.Y. — Aug. 29-31

ABA members will qualify for a registration discount. For more information, visit www.taxforuminfo.com.

LAW STUDENT TAX CHALLENGE

The Section is pleased to announce the winners of the 2005 Law Student Tax Challenge:

J.D. DIVISION RESULTS

1st Place	Tonita Northington and Teri Ellison, Louisiana State University Law Center
2nd Place	Mary Riley and Cathryn Streeter, Northern Illinois University College of Law
3rd Place	Gainey Johnson and Travis Combs, University of Houston Law Center
Best Written Submission	Jed Tomkins and Luke Jones, Lewis and Clark Law School

LL.M. DIVISION RESULTS

1st Place	Kelley Miller and Michael Gitlin, Georgetown University Law Center
2nd Place	Jeffrey Malo and Agnieszka Samoc, Georgetown University Law Center
Best Written Submission	Jeffrey Malo and Agnieszka Samoc of Georgetown University Law Center

For the first time, this year's competition included both J.D. and LL.M. students; the top seven J.D. teams and the top four LL.M. teams traveled to San Diego, California to compete in the oral rounds at the Section's Midyear Meeting.

The Law Student Tax Challenge (LSTC) is a national tax planning competition sponsored by the Young Lawyers Forum of the Section of Taxation and designed to reflect everyday tax practice more accurately than traditional moot court competitions. The LSTC offers students the opportunity to demonstrate their acquired knowledge and interact with experienced practitioners and potential future employers. The top-performing students are recognized before the Section of Taxation and receive prizes, including monetary awards. In the competition's four year history, the LSTC has become one of the largest tax competitions for law students in the United States.

A complete listing of the teams entered in the 2005 competition, along with samples of entries, is available on the Section's Web site at: http://www.abanet.org/tax/lstc. ■

CLE CALENDAR

All programs listed below are subject to rescheduling or cancellation. For the latest information, please refer to the corresponding contact information.

DATE	PROGRAM	INFORMATION
May 17	**SALT & Tax Shelters - Policy, Practices & Problems** Washington, DC, Georgetown University Law Center CLE	ABA Tax Section **www.law.georgetown.edu/cle** 202-662-9890
May 31	**"Last Wednesday" Teleconference: New Bankruptcy Act - Tax and Nontax Issues Relating to the Closely Held Business and Its Owners**	ABA Tax Section **www.abanet.org/tax** 202-662-8670
June 8-9	**Charitable Giving Techniques**, Boston, MA	ALI-ABA **www.ali-aba.org** 800-253-6397
June 22	**Tax CLE on the Road: Tax Aspects of Real Estate Transactions** Atlanta, GA	ABA Tax Section; Atlanta Bar Tax Section; Georgia Bar Tax Section **www.abanet.org/tax** 202-662-8670
June 28	**"Last Wednesday" Teleconference: Fiduciary Income Tax (Topic TBA)**	ABA Tax Section **www.abanet.org/tax** 202-662-8670
July 19-21	**Estate Planning for the Family Business Owner** Chicago, IL	ALI-ABA **www.ali-aba.org** 800-253-6397
August 3-8	**ABA Annual Meeting** Honolulu, HI	ABA Meetings & Travel **www.abanet.org/annual/2006** 800-285-2221
October 5-6	**Consolidated Tax Return Regulations** Washington, D.C.	ALI-ABA **www.ali-aba.org** 800-253-6397

SECTION MEETING CALENDAR

www.abanet.org/tax/meetings

2006	**JOINT FALL CLE MEETING**, **October 19-21**, Hyatt Regency, Denver, CO
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
2008	**MIDYEAR MEETING**, **January 17-19**, Hyatt Regency and Ritz Carlton, Lake Las Vegas, NV
	MAY MEETING, **May 8-10**, Grand Hyatt, Washington, DC
	JOINT FALL CLE MEETING, **October 9-11**, Hyatt Regency, Chicago, IL

POINTS

POINTS TO REMEMBER

FROM PAGE 21

at least six months after a termination of service.

AMENDING EXISTING ARRANGEMENTS

Employers should review separation plans and employment contracts to ensure that timing of payments as well as the benefits payable under those plans either comply with or are exempt from section 409A. Additionally, if the Service maintains an unfavorable position on good reason provisions, the parties to a severance contract, especially for key employees at public companies, should determine whether the existence of a constructive termination provision is more important than potentially having to wait at least six months for severance payments to begin. The Preamble to the proposed regulations provides that such amendments to comply with section 409A may only be made until December 31, 2006, so employers should undertake such reviews as soon as possible. ■

GOVERNMENT SUBMISSIONS **BOXSCORE**

Since February 2006, the 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 SUBMISSIONS TO U.S. TREASURY DEPT. AND IRS*

I.R.C. §	DATE	TITLE	COMMITTEE	CONTACT
411(d)(6)	03/31/06	Section Comments on Proposed Regulations under Section 411(d)(6)	Employee Benefits	Joni L. Andrioff, Kurt L.P. Lawson
409A	03/09/06	Section Comments on Deferral Elections under IRC Section 409A Proposed Regulations	Employee Benefits	Kurt L. P. Lawson, David Mustone
199	03/03/06	Section Comments Concerning the Proposed Regulations under Section 199	Tax Accounting	C. Ellen MacNeil
409A	02/27/06	Section Comments on Stock Rights and Service Recipient Stock under IRC Section 409A Proposed Regulations	Employee Benefits	Wayne R. Luepker, Carol A. Weiser
409A	02/27/06	Section Comments on the Valuation of Private Company Stock and Modification of Stock Options and Stock Appreciation Rights under IRC Section 409A Proposed Regulations	Employee Benefits	Wayne R. Luepker, Scott Spector
409A	02/22/06	Section Comments on Nonqualified Deferred Compensation Focusing on Foreign Plan Aspects under Internal Revenue Code Section 409A Proposed Regulations	Employee Benefits	Russell E. Hall, David W. Ellis
409A	02/16/06	Section Comments on Separation from Service Issues Under Internal Revenue Code Section 409A Proposed Regulations	Employee Benefits	Wayne R. Luepker
704(c)	02/01/06	Section Comments Concerning Notice 2005-15	Partnerships and LLCs	Christopher McLoon

SUBMISSIONS TO CONGRESS AND THE U.S. TAX COURT*

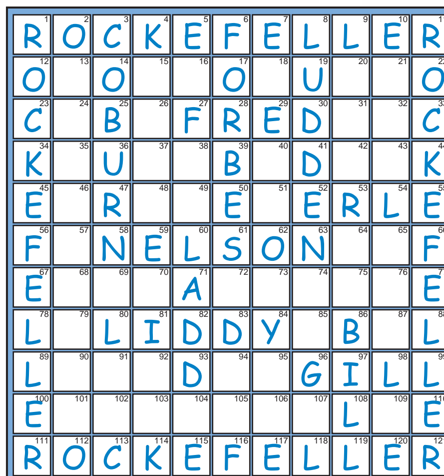
TO	DATE	TITLE
Finance / Ways and Means	02/02/06	Section Comments Regarding S.2020 (re: Charitable Organizations)
US Tax Court	02/02/06	Letter to US Tax Court Chief Judge on Privacy Protection for Filings Made with the Court
US Tax Court	02/02/06	Section Comments Concerning the Tax Court's Proposed Interim Rule and Interim Procedures Regarding E-Filing Pilot Program

* The submissions listed in these indexes represent the views of the ABA Section of Taxation. They have not been approved by the ABA Board of Governors or the ABA House of Delegates and should not be construed as representing the policy of the ABA.

TAX BiTES PUZZLER CONQUERS ALL

Compiled by Gail Levin Richmond, Fort Lauderdale, FL

Tax lawyers are digesting new legislation, administrative pronouncements, and judicial opinions, but we hadn't realized just how busy they were. Your editor received no entries to the Winter 2006 issue Puzzler contest. Could it have been the prize, a stint as guest columnist? In any event, here are the answers to the puzzle's Across and Down clues.



Across

1 Rockefeller v. Commissioner, 676 F.2d 35 (2d Cir. 1982) (David Rockefeller & assorted other Rockefellers)
27 MacMurray v. Commissioner, 21 T.C. 15 (1953) (Fred MacMurray)
52 Gardner v. United States, 80-1 U.S. Tax Cas. (CCH) ¶ 13,355; 46 A.F.T.R.2d (RIA) 6139 (C.D. Cal. 1980) (Erle Stanley Gardner's estate)
58 Nelson v. Commissioner, 25 T.C.M. (CCH) 1142 (1966) (Ozzie Nelson)
80 Liddy v. Commissioner, 808 F.2d 312 (4th Cir. 1986) (G. Gordon Liddy)
96 Gill v. United States, 97-2 U.S. Tax Cas. (CCH) ¶ 50,918; 80 A.F.T.R.2d (RIA) 7384 (Fed. Cl. 1997) (Andre Gill)
111 Rockefeller Family Cemetery Corporation v. Commissioner, 63 T.C. 355 (1974) (John D. Rockefeller)

Down

1 Rockefeller v. United States, 718 F.2d 290 (8th Cir. 1983) (Winthrop Rockefeller)
3 Coburn v. Commissioner, 138 F.2d 763 (2d Cir. 1943) (Charles Coburn)
6 Forbes v. Commissioner, 18 T.C. 321 (1952) (Bertie Charles Forbes)
8 Ludden v. Commissioner, 68 T.C. 826 (1977) (Allen Ludden)
11 Estate of Rockefeller v. Commissioner, 83 T.C. 368 (1984) (Nelson Rockefeller)
60 Ladd v. Riddell, 309 F.2d 51 (9th Cir. 1962) (Alan Ladd)
86 Kenyatta Corporation v. Commissioner, 812 F.2d 577 (9th Cir. 1987) (Bill Russell)

ABA SECTION OF TAXATION

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10th Floor
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