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# NEWSQUARTERLY

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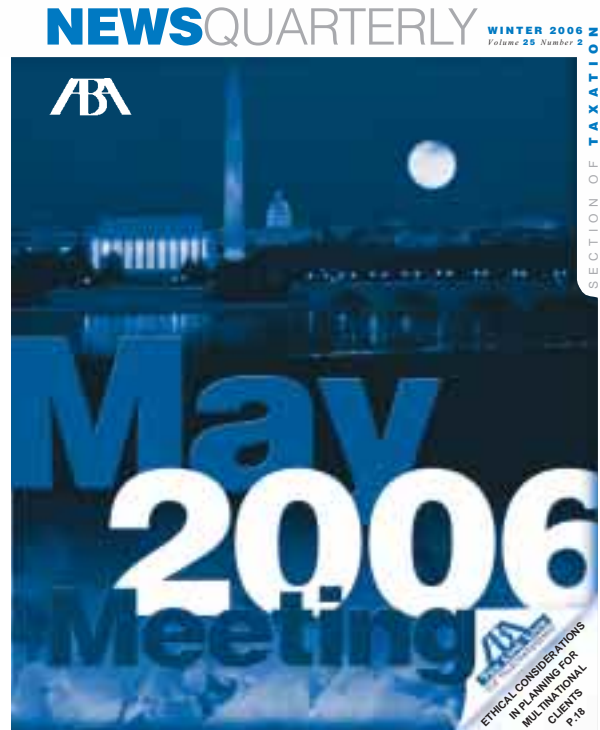
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# FROM THE CHAIR

by Dennis B. Drapkin, Dallas, TX



DENNIS B. DRAPKIN

## TAX REFORM

On November 1, 2005, after some delays, the President's Advisory Panel on Federal Tax Reform made its report to the Secretary of the Treasury. This is the latest step in a process that the President set in motion in January 2005 with the creation of the Panel by executive order. The report recommends two extensive proposals, one directed at reforming the existing federal income tax and the other at moving towards a consumption-based tax system. Both proposals present broad outlines of changes in the federal tax system, but do not provide extensive detail or legislative language.

On November 17, 2005, I wrote on behalf of the Section to former Senators Connie Mack and John Breaux, the leaders of the Tax Reform Panel, commending the Panel on the completion of its work. The letter embraced the report's emphasis on tax simplification, which the ABA has made a legislative priority, and noted that the report included several specific simplification proposals advocated by the ABA, such as repeal of the alternative minimum tax and repeal of income "phase-outs." We also stated our willingness to provide technical

assistance as the tax reform process moves forward.

As of this writing, it remains unclear whether and how the federal tax reform process will continue. It is possible that the President will discuss tax reform in his State of the Union address, and that those remarks may be accompanied by the release of specific tax reform proposals. Other indications suggest that tax reform proposals may not emerge until next year. In any event, when more detailed tax reform proposals are made by the Administration, the Section will consider how it can best participate in the tax reform process.

## CIRCULAR 230

Even before the final Circular 230 written tax advice regulations became effective on June 20, 2005, practitioners had begun to voice their concerns about the resulting burdens placed on the tax system. Complaints have steadily increased, while at the same time, enormous efforts have been made by practitioners and their firms to comply with the new rules.

Understandably erring on the side of caution, many practitioners have undertaken the time and expense of applying the new rules each time written tax advice is considered, frequently resulting in the "legending" of written communications in order to avoid noncompliance. Individual comments to the Government have diverged widely in their approaches. Some recommend the issuance of binding confirmation from the Government on the application of the regulations to specific fact patterns, taking the form of "frequently asked questions." Others make proposals to revise the regulations based on experience in specialized areas of practice, such as capital markets and wealth transfer. Occasionally, practitioners argue that the burdens imposed on the tax system seem vastly disproportional

to the benefits obtained, and call for repeal of the most troublesome provisions.

On December 5, 2005, the Section submitted a letter to the Government making many similar observations and requesting immediate action. The letter enumerated the principal undesirable consequences caused by the written tax advice regulations: the necessity to evaluate all proposed written communications against the new technical rules and then to decide on appropriate compliance measures, which acts as a barrier to seeking advice in the first place; the proliferation of legending to avoid noncompliance, with resulting confusion and discord; the pressure created to issue oral rather than written advice; and the concern with the possibility that the Government may find fault with technical violations of the new rules rather than focusing on compliance with core ethical principles. The letter concluded that any benefit produced by the new rules in combatting tax shelters was more than offset by the barriers imposed to obtaining written advice, and that overall tax compliance might well be reduced rather than enhanced. The letter then urged the Government to revise the Circular 230 regulations to align them more closely with their objectives, noting many suggestions previously made by the Section to achieve those goals that had not been adopted, or, alternatively, to request proposals for interpretations of Circular 230 as applied to specific fact situations (i.e., publish responses to "frequently asked questions"). The letter also noted that other approaches could be devised to improve the administrability and effectiveness of the Circular 230 written tax advice rules.

At this writing, I am hopeful that the Government will revisit the Circular 230 written tax advice regulations with the goal of making them



more workable and less burdensome. The Section remains willing, as it consistently has in the past, to assist the Government in developing rules to address tax shelter opinion abuses, while assuring that the impact of the regulations does not unduly burden the ability of practitioners to provide written tax advice.

## SECTION ACTIVITY IN RESPONSE TO THE HURRICANES

The Section has continued to monitor the guidance published by the Government in response to tax issues presented by the aftermath of the major hurricanes and to review the legislative initiatives considered by Congress. In addition, in November 2005, the Section entered into a Memorandum of Understanding (MOU) with the IRS that creates an informal partnership to provide assistance to taxpayers at local FEMA disaster recovery centers in response to the hurricanes. Entering into these MOUs has been a high priority for the IRS. The MOU provides an excellent opportunity for the Section to fulfill its objective to provide direct personal assistance to taxpayers adversely affected by the hurricanes. I am grateful to Sylvan Siegler, Vice Chair - Administration, and Greg Jenner, Vice Chair - Communications, for their efforts in working out an acceptable MOU.

## MEETINGS WITH THE GOVERNMENT

On December 8, 2005, Section officers met with senior officials at the IRS and the Treasury Department to discuss issues of current importance. As in the past, the meetings resulted in a useful interaction that emphasized the views of our members and the Section's participation in fostering improvements to the tax system. This year, our discussions focused on Circular 230, federal tax reform, the new nonqualified deferred compensation rules, certain aspects of the tax shelter regulations, and gui-

dance issued this fall in the aftermath of the hurricanes. In addition, we discussed with the IRS the Section's interest in surveying our members regarding the independence and effectiveness of the appeals process.

## RECENT GOVERNMENT SUBMISSIONS

The Section has been active in providing the Government with timely comments on a wide range of subjects:

- At the request of the Director of the Office of Professional Responsibility, the Section, through its Standards of Tax Practice Committee, examined whether Tax Court Special Trial Judges would be a more appropriate trier of fact in OPR disciplinary hearings than the administrative law judges who currently hear these cases. These comments are noteworthy due to the substantial contributions made by the Section of Administrative Law, the Judicial Division and the ABA's Standing Committee on Professional Responsibility.
- The Committee on U.S. Activities of Foreigners and Tax Treaties prepared comments on regulations relating to the obligations of partnerships to withhold tax under section 1446 on effectively connected taxable income allocated to foreign partners.
- The Employee Benefits Committee urged the expansion of transition relief granted under proposed regulations interpreting recently enacted section 409A.
- The Exempt Organizations and Employee Benefits Committees made recommendations for guidance in response to the aftermath of Hurricanes Katrina and Rita.
- The Committee on Financial Transactions prepared comments concerning proposed regulations under section 475 relating to elective safe harbors for dealers in securities, dealers in commodities, and traders in securities and commodities.

- The Employee Benefits Committee submitted detailed comments in response to proposed regulations issued under section 415.
- The Section submitted comments on pending legislation regarding codification of the economic substance doctrine, offers in compromise, frivolous tax returns, exempt organizations and charitable contributions.

## PUBLICATIONS DEVELOPMENTS

Through the outstanding efforts of our Vice Chair - Publications, Jerry August, and Council director Sam Braunstein, the Section and THE PRACTICAL TAX LAWYER, an ALI-ABA publication that is cosponsored by the Tax Section, have commenced a collaborative effort in which experienced members of the Section are paired with members of the Section's Young Lawyers Forum and Diversity Committee to co-author articles for publication. This project was inaugurated with the publication of two articles in the Fall 2005 issue of THE PRACTICAL TAX LAWYER. We expect that at least one article resulting from this mentoring program will be published in each issue of THE PRACTICAL TAX LAWYER.

## 2006 MIDYEAR MEETING

We are looking forward to an excellent Midyear Meeting, February 2 - 4, 2006, at the Manchester Grand Hyatt Hotel in San Diego. Hurricane Katrina forced us to relocate the meeting from New Orleans, and we were fortunate to be able to return to last year's outstanding venue. The Manchester Grand Hyatt has graciously agreed to allow the Section to reschedule its 2009 Midyear Meeting, thereby providing an opportunity to return to New Orleans. The Section will contribute \$25 to one or more charities assisting those affected by Hurricane Katrina for each person who registers for the 2006 Midyear Meeting.

SEE FROM THE CHAIR, PAGE 23

# POINTS TO REMEMBER

**INTRODUCTION:** The two Points in this issue address very different but equally timely subjects. In the first, Francine Lipman and Sean Stegmaier provide a primer on the tax consequences of natural disasters, including the legislation recently enacted in response to the devastation that followed Hurricane Katrina, as well as the prospect of legislation that would extend the new provisions to victims of Hurricanes Rita and Wilma. Next, Matt Belcher and Glen Mincey describe long-awaited and recently proposed regulations on the award of compensatory partnership equity interests and explain how tax advisors will have to modify what is now standard practice if these proposals are finalized.

—Alice G. Abreu, Philadelphia, PA

## RELIEF FROM THE RUBBLE: TAX ASSISTANCE FOR VICTIMS OF THE 2005 HURRICANE SEASON

by Francine J. Lipman and Sean M. Stegmaier, Orange County, CA

A record-breaking hurricane season in 2005 pounded the South with some of the most extreme weather and tragic losses that we have seen in a very long time. August brought Hurricane Katrina, an overwhelming and historically destructive disaster, to the Gulf Coast, displacing millions and injuring and killing thousands of people. September brought Hurricane Rita and its 100-plus-mile-an-hour winds and relentless rain back to the battered southeast. October brought Hurricane Wilma, destroying homes and businesses across Florida. Hundreds of billions of dollars of losses and thousands of lives were swept away in these three horrible hurricanes.

Homeless and devastated, thousands of victims have relocated either

temporarily or permanently. As they begin to reassemble the pieces of their lives, they have a number of questions relating to the tax consequences of their losses and their receipt of disaster relief.

This article will address the most common tax questions facing disaster victims and provide answers for victims of presidentially declared disasters generally and Hurricane Katrina victims specifically. Although the tax laws generally provide relief for taxpayers who have suffered casualty losses, they provide more favorable treatment for victims of disasters that have been declared a major disaster by the President. Victims of Hurricane Katrina have been provided even more favorable treatment under the Katrina Emergency Tax Relief Act of 2005 (KETRA) signed into law by President Bush in late September. As this article goes to press members of Congress are considering extending the more favorable tax treatment under KETRA to victims of Hurricanes Rita and Wilma.

## DISASTER LOSSES AND DEFERRAL OF DISASTER GAINS RECOGNITION OF CASUALTY LOSSES

The most common tax relief provisions available for victims of disasters are casualty loss deductions and the deferral of recognition of casualty gains. If a victim of a presidentially declared disaster suffers losses that are not fully reimbursed, she may either claim a deduction for the year in which the loss occurred or deduct the loss in the prior tax year by filing an amended return. By taking the deduction in the prior year, the taxpayer may receive a greater tax benefit and an immediate refund. Taxpayers have until the due date (without extensions) of their tax return for the year in which the disaster actually occurred to amend their prior year tax return to claim any available casualty loss deduction. Therefore, taxpayers will each have to amend their 2004 tax

returns no later than April 15, 2006, if they elect to deduct their 2005 casualty losses in 2004.

## CASUALTY LOSS CALCULATIONS

Unless Congress acts, victims of hurricanes Rita and Wilma will be subject to less favorable tax treatment than victims of Katrina. This less favorable treatment for victims of presidentially declared non-Hurricane Katrina disasters depends upon whether the property damaged was used personally or for business.

## PERSONAL USE PROPERTY

Taxpayers calculate their casualty losses on personal use property by taking the lesser of the adjusted basis of the property or the decrease in fair market value due to the disaster, and then subtracting any insurance or other reimbursement taxpayers have received or expect to receive. This calculation may provide an unpleasant surprise for taxpayers who have suffered a loss of unrealized appreciation. Because the unrealized appreciation in their property was never recognized, the loss of the appreciation does not give rise to a tax deduction.

When calculating casualty losses, a taxpayer must take into account the amount of insurance payments that she *expects* to receive. If a taxpayer later receives less insurance money than expected, she may include that difference as a loss for the tax year in which she expects no further insurance or other reimbursement. If a taxpayer chooses not to file an insurance claim, then her disaster loss cannot exceed the amount of her insurance deductible.

## LIMITS ON CASUALTY LOSS DEDUCTIONS FOR PERSONAL USE PROPERTY

Casualty losses are deductible only to the extent they exceed \$100 (per event) plus an overall limit of 10% of the taxpayer's adjusted gross income

(AGI). Casualty losses are itemized deductions, not subject to the cutback of itemized deductions for high-income taxpayers or any adjustment under the alternative minimum tax (AMT). If casualty losses exceed a taxpayer's income for the tax year in which she claims the loss, the taxpayer may have a net operating loss (NOL). A taxpayer can offset an NOL against taxable income in her two prior tax years, generating a refund. Any excess NOL will offset future taxable income, providing a tax benefit in the subsequent twenty years until exhausted. However, if a taxpayer does not itemize her deductions and claims the standard deduction, she will not receive any tax benefit from her casualty loss deduction.

#### NO LIMITS FOR HURRICANE KATRINA VICTIMS

Under KETRA, the \$100 and 10% of AGI limits on personal use property casualty losses have been deleted to the extent they arise in the Hurricane Katrina disaster area on or after August 25, 2005 and are attributable to Hurricane Katrina.

#### BUSINESS USE PROPERTY

Business use property casualty losses are determined in the same manner as personal use property casualty losses except that they are not subject to the \$100 (per event) or the 10% AGI limits. In addition, business casualty losses are generally treated as deductions in arriving at AGI and not as itemized deductions unless the loss arises out of an employee relationship. Casualty losses of property used as an employee are characterized as "miscellaneous itemized deductions" only deductible to the extent they exceed 2% of AGI and not deductible for AMT purposes.

#### DEFERRAL OF CASUALTY GAINS

Taxpayers realizing a gain on the involuntary conversion of their property into cash may defer gain recognition if they elect to purchase an adequate amount of qualifying replacement

property within the replacement period. Qualifying replacement property is property that is "similar or related in service or use" to the destroyed property. While there is no definition of "similar or related in service or use," the government has narrowly applied this definition in numerous interpretive rulings. However, for presidentially declared disasters if the damaged property was used in a trade or business or held for investment, this definition is expanded significantly to include **any** tangible property held for productive use in a trade or business or for investment. The replacement period for property destroyed in a presidentially declared disaster area is two years from the close of the tax year in which any gain is first realized. A taxpayer with reasonable cause for not being able to replace within this period may apply for an extension.

A taxpayer must recognize gain realized to the extent the conversion proceeds exceed the purchase price of qualifying replacement property. Taxpayers may retain their cash and finance the purchase of qualifying replacement property without adverse tax consequences if their purchase price is at least equal to the conversion proceeds. However, a taxpayer's basis in the replacement property will be its cost, reduced by the amount of any deferred gain. A taxpayer's holding period in the replacement property will include the holding period in the damaged property.

A taxpayer electing to defer gain recognition must attach a statement to her tax return for any year she has realized casualty gain. She must attach another statement to her return containing information about the purchase of any qualifying replacement property for each tax year during the replacement period. If a taxpayer fails to purchase an adequate amount of qualifying replacement property within the replacement period, she must file an amended return for the year she realized her gain and report any gain that cannot be deferred.

#### PRINCIPAL RESIDENCE CASUALTY GAINS

A taxpayer may exclude a maximum of \$250,000 (\$500,000 if married filing jointly) of gain on the qualifying sale, including an involuntary conversion, of a principal residence. If a personal residence casualty gain is more than the allowable exclusion amount, a taxpayer can defer recognizing any excess gain by purchasing qualifying replacement property within four years of the close of the tax year in which any gain is first realized.

In addition, a taxpayer does not have to recognize gain on any insurance proceeds received for unscheduled personal property that was part of the contents of the taxpayer's residence. Any insurance proceeds received from the taxpayer's principal residence or scheduled personal property can be treated as received for a single item of property for measuring the required amount of reinvestment. A taxpayer can postpone recognizing any gain realized by purchasing replacement property that is similar or related in service or use to the residence or its contents.

#### HURRICANE KATRINA VICTIMS

Victims of Hurricane Katrina will have five years to replace **any** property located in the Hurricane Katrina disaster area, which is compulsorily or involuntarily converted on or after August 25, 2005, by reason of Hurricane Katrina, but **ONLY** if substantially all of the replacement property is located in the Hurricane Katrina disaster area.

#### EXTENSION OF TAX DEADLINES FOR VICTIMS OF HURRICANES KATRINA, RITA, OR WILMA

Taxpayers affected by Hurricanes Katrina, Rita, or Wilma will have until February 28, 2006, to file returns, pay taxes and perform other time-sensitive acts due in 2005. The IRS encourages all victims of these hurricanes to identify themselves by writing "Hurricane Katrina, [Rita] or [Wilma]" in red ink



at the top of their tax forms or any other filed documents. Victims of these three disasters can get free copies of prior tax returns and tax records from the IRS on an expedited basis.

#### ADDITIONAL TAX RELIEF UNDER KETRA

Congress has provided enhanced tax relief for victims of Hurricane Katrina. While more disaster relief is expected, including a possible expansion of these benefits to victims of Hurricanes Rita and Wilma, to date KETRA provides the following tax relief only for victims and heroes of Hurricane Katrina (unless otherwise noted).

- **Earned Income Tax Credits and Refundable Child Tax Credit** calculations for qualifying low-income victims for tax year 2005 may be based upon 2004 earned income.
- **Preservation of dependency exemptions, filing status, etc.** for taxpayers who may jeopardize tax benefits because of temporary relocations caused by Hurricane Katrina.
- **Additional personal exemptions** for taxpayers who house (rent-free) dislocated persons from Hurricane Katrina for a minimum of 60 days in their principal residences. The additional exemption is \$500 per person to a maximum of \$2,000 per year for 2005 or 2006. This deduction is not phased-out and is allowed under the AMT.
- **Gross income exclusion** for certain cancellation of nonbusiness indebtedness for discharges made through December 31, 2006.
- **Retirement plan withdrawals, rollovers and loans** will be more favorable. Eligible victims may withdraw a maximum of \$100,000 from their IRAs and pensions without paying the 10% early withdrawal penalty and may pay any income tax on the distribution ratably over a 3-year period beginning on the date

of the distribution. Income tax is not due if the distribution is repaid to the account within 3 years.

Any portion of a qualified distribution may, during the period beginning August 25, 2005, and ending February 28, 2006, be recontributed to a plan, annuity, or IRA to which a rollover is permitted and excluded from a taxpayer's gross income.

Allowable tax-free loan limits are increased through 2006 and loan due dates from August 25, 2005 through December 31, 2006 are extended one year.

- **A new Work Opportunity Tax Credit target group** for Hurricane Katrina employees comprised of individuals who, prior to the hurricane, lived in the area that is now within the disaster zone. Employers hiring Hurricane Katrina employees will qualify for a 40% credit on the first \$6,000 of wages paid to the employee in the first year.
- **Employee retention credit** for small employers located in the disaster area. The tax credit equals 40% of the first \$6,000 of wages paid to employees between August 28, 2005 and before January 1, 2006. The credit is available to small employers whose businesses are inoperable as a result of damage sustained by Hurricane Katrina. The credit is not affected if the employee reports to work at another location during the period the business is inoperable.
- **Greater access to mortgage revenue bond proceeds** by waiving the first-time homebuyer requirement through 2007 for qualified Hurricane Katrina recovery residences and providing loans up to \$150,000 for repairs to damaged homes.
- **Charitable donations will be given tax favored treatment.** Suspension of limits on charitable contributions for individuals and

corporations in 2005. Individuals may elect to deduct cash contributions made from August 28, 2005 to December 31, 2005 to qualifying charities in an amount equal to 100% of AGI. This deduction will be an itemized deduction not subject to the overall itemized deduction limit for high-income taxpayers. Corporations may elect to deduct cash contributions for relief efforts related to Hurricane Katrina made during the same period in an amount equal to 100% of their taxable income.

Donations of educational books to public schools and food inventory will be enhanced to the lesser of (i) basis plus 1/2 of the item's appreciated value or (ii) two times the basis for any business through 2005.

Charitable mileage deductions will be computed using a rate equal to 70% of the business mileage rate in effect on the date of the contribution, provided the taxpayer uses the vehicle in providing donated services solely for the purpose of relief related to Hurricane Katrina. Volunteers may exclude from gross income reimbursements for the costs of using vehicles up to an amount that does not exceed the business standard mileage rate through 2006 (44.5 cents as of January 1).

#### TREASURY ISSUES MUCH-ANTICIPATED PROPOSED PARTNERSHIP EQUITY COMPENSATION REGULATIONS

by Matthew Belcher and Glenn Mincey, New York, NY

**O**n May 20, 2005, the Internal Revenue Service ("IRS") and the Treasury Department ("Treasury") issued much-anticipated proposed regulations (the "Proposed Regulations") addressing the U.S. federal income tax treatment of certain transfers of partnership equity (including options to acquire partnership equity) in connection with the performance of services ("compensatory partnership interests"). The Proposed Regulations

are generally taxpayer friendly and appear to contain few surprises. The Treasury and the IRS also issued Notice 2005-43, 2005-24 I.R.B. 1, (the "Notice") containing a proposed revenue procedure that provides additional guidance for partnerships that transfer compensatory partnership equity. The Notice provides that the proposed revenue procedure will be finalized once the Proposed Regulations are finalized. The Notice also provides that Rev. Proc. 93-27, 1993-2 C.B. 343, and Rev. Proc. 2001-43, 2001-2 C.B. 191, will be obsoleted when the proposed revenue procedure becomes final. What follows is a brief summary of the more significant issues addressed by the Proposed Regulations:

**All Partnership Interests Are Property for Purposes of Section 83.** Section 83(a) provides rules regarding the taxation of property transferred in connection with the performance of services. For example, section 83(a) provides that income inclusion occurs in the first year in which the property received is vested, *i.e.*, when the property is transferable or is not subject to a substantial risk of forfeiture. Although some practitioners have argued that partners and partnerships are simply outside the scope of section 83, the Proposed Regulations specifically provide that a partnership interest—whether a capital interest or a profits interest—will be treated as property within the meaning of section 83, and the transfer of a compensatory partnership interest will be subject to section 83. Accordingly, the excess of the fair market value of the partnership interest received by the service provider over the amount, if any, paid by the service provider will generally be includible in income during the taxable year of the service provider in which the partnership interest is substantially vested (within the meaning of section 83(a) and Treas. Reg. § 1.83-3(b)). Further, the service provider will be treated as a partner at that time.

The timing of the deduction for the partnership will also be governed by section 83. Thus, the deduction will be recognized in the taxable year of the partnership that ends within or with the taxable year of the service provider in which compensation under section 83 will be included in the service provider's income, unless the interest is vested upon receipt, in which case the partnership claims the deduction in accordance with its normal method of accounting. As a general matter, partners are free to allocate items of loss and deduction as they see fit, subject to the requirements of section 704(b). Nevertheless, section 706(d)(1) generally provides that, if there is a change in any partner's interest in a partnership during a taxable year, each partner's distributive share of the partnership's income, gain, loss, deduction, and credit must be determined in a manner that takes into account the varying interests of the partners. According to the Preamble to the Proposed Regulations, the government believes that section 706(d)(1) "adequately ensures that partnership deductions that are attributable to the portion of the partnership's taxable year prior to a new partner's entry into the partnership are allocated to the historic partners." Preamble at 29,677.

**Liquidation Value Approach Still Available.** Consistent with Rev. Proc. 93-27 and Rev. Proc. 2001-43, a safe harbor election (the "Safe Harbor") will be available to permit partnerships to value compensatory partnership interests using the liquidation value approach. As a result, the receipt of a profits interest will not result in income to the recipient if the Safe Harbor election is made. Accordingly, the full fair market value of the partnership interest received by the service provider will generally be includible in income during the taxable year in which the partnership interest is no longer subject to a substantial risk of forfeiture or becomes transferable. Nevertheless, consistent with Rev. Proc. 93-27 and Rev. Proc. 2001-43, a safe harbor election can be made by the partnership to value compensatory

partnership interests using the liquidation value approach. As a result, the flexibility previously afforded under the revenue procedures is preserved. Consistent with section 83 principles, the Proposed Regulations provide that, if a partnership interest is transferred in connection with the performance of services, and if an election under section 83(b) is not made, then the holder of the partnership interest is not treated as a partner until the interest becomes substantially vested. The Proposed Regulations provide that a service provider who receives a partnership interest in connection with the performance of services and makes a section 83(b) election will be treated as a partner.

**Section 83(b) Elections Required for Unvested Interests.** Section 83(b) allows a service provider to elect to treat restricted property as if it were substantially vested on transfer and include in income the amount, if any, that would be included in income if the property were in fact substantially vested on transfer. The service provider does not subsequently include additional compensation income when the property in fact becomes substantially vested. If the property is later forfeited, however, the service provider is not entitled to claim a loss in respect of such forfeiture. I.R.C. § 83(b)(1). Under the Proposed Regulations, however, a service provider who receives a restricted (*i.e.*, unvested) partnership interest in connection with the performance of services would need to make a section 83(b) election to be treated as a partner prior to vesting. The timing for making a section 83(b) election is limited. Such election must be made within 30 days of transfer. The specific requirements for making such an election are contained under Treas. Reg. § 1.83-2. If a partnership interest is transferred in connection with the performance of services, and if an election under section 83(b) is not made, the holder of the partnership interest would not be treated as a partner until the interest becomes substantially vested. Under current



administrative guidance, the recipient of an unvested profits interest does not need to make a section 83(b) election so long as the profits interest falls within the parameters of Rev. Proc. 2001-43. For profits interests that are currently covered by Rev. Proc. 2001-43, requiring a section 83(b) election imposes new administrative burdens without changing the tax result.

**No Gain or Loss Recognized by Partnership on Issuance of Interest.**

While some tax practitioners believed that the issuance of a partnership interest in exchange for services could cause the issuing partnership to recognize gain or loss, the Proposed Regulations provide that a partnership will recognize neither gain nor loss on the issuance or vesting of a partnership interest (whether a profits interest or a capital interest) issued in connection with the performance of services for the issuing partnership. The Preamble to the Proposed Regulations states:

[T]he Treasury Department and the IRS believe that partnerships should not be required to recognize gain on the transfer of a compensatory partnership interest. Such a rule is more consistent with the policies underlying section 721 – to defer recognition of gain and loss when persons join together to conduct a business – than would be a rule requiring the partnership to recognize gain on the transfer of these types of interests. Therefore, the proposed regulations provide that partnerships are not taxed on the transfer or substantial vesting of a compensatory partnership interest. Preamble to Proposed

Regulations, 70 Fed. Reg. 29,675 (May 24, 2005).

**Special “Forfeiture Allocations” Required.** Allocations are supposed to affect the amount that a partner would receive on the liquidation of his or her partnership interest. Practitioners have long been concerned that, in situations in which a partner’s interest is unvested, the IRS might argue that an allocation of income to that partner does not satisfy the section 704(b) regulations because, if the service provider were to forfeit her interest, she would receive nothing. Notwithstanding this uncertainty, most practitioners have concluded that the potential for forfeiture should be ignored, provided that the service provider makes an election under section 83(b) or was not required to make such an election (by virtue of Rev. Proc. 2001-43). The Preamble explains that allocations of partnership items to the holder of an unvested interest cannot have economic effect because there is a possibility that the partnership might not liquidate in accordance with positive capital account balances, as is required by the safe harbor regulations under section 704(b). For this reason, the Proposed Regulations provide that such allocations “cannot have economic effect.” Nevertheless, the Proposed Regulations would permit such allocations to be made by adopting a special rule that would treat such allocations as being in accordance with the partners’ interests in the partnership. To satisfy this rule, where a service provider makes a section 83(b) election with respect to a substantially unvested partnership interest and later forfeits that interest, the partnership

would be required to make reversing allocations of income or loss (so-called “forfeiture allocations”) to the service provider.

**Regulations Effective When Finalized.** The Proposed Regulations will apply to issuances of compensatory partnership interests and options that occur on or after the date final regulations are published in the Federal Register.

**NEXT STEPS**

Even though the Proposed Regulations will apply prospectively from the date such regulations are finalized, partnership agreements should include, or should be amended to include, a provision that would permit the partnership to make an election to use the liquidation value approach in valuing compensatory partnership interests. Such provisions would enable taxpayers to receive the same tax treatment that is currently afforded service providers under Rev. Proc. 93-27 and Rev. Proc. 2001-43.

The Proposed Regulation and the proposed revenue procedure confirm that partnerships issuing compensatory equity will not recognize gain. Nevertheless, because the Proposed Regulations and the proposed revenue procedure will change the way that taxpayers and practitioners have approached the issuance of partnership equity, they pose traps for the unwary. Practitioners should pay close attention to further developments in this area. ■

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# POINT & COUNTERPOINT:

## SHOULD THE HOME MORTGAGE INTEREST TAX BENEFIT BE REDUCED?

**INTRODUCTION:** Included among the President's Advisory Panel on Federal Tax Reform's recommendations were three proposals related to the current home mortgage interest deduction. Instead of a deduction, the panel recommended a flat 15% credit. Instead of the current \$1,100,000 mortgage caps, the panel recommended a mortgage cap based on the median regional price of housing. Finally, the panel recommended limiting the deduction to interest paid on only one home and eliminating the deduction for interest on home equity indebtedness. See Report of the President's Advisory Panel on Federal Tax Reform 70-75 (2005) (hereinafter cited as *Panel Report*).

The Panel Report praises the Tax Reform Act of 1986, albeit with a caveat: "While the 1986 Act was a historic event, it did not produce a lasting transformation of the tax system. The 1986 Act left in place or added various complicated tax benefits, including such items as exclusions for employer-provided fringe benefits, state and local tax deductions, tax-deferred annuities, new mortgage interest deduction rules, and complicated rules for determining alternative minimum tax liability. Many point to the 1986 Act as the high point of contemporary tax reform—and they may well be right—but its limitations suggest that truly sweeping comprehensive reform faces formidable political obstacles." *Panel Report* at 14.

Both participants in the debate refer to the 1986 Act in discussing the Panel's proposals relating to the tax treatment of home mortgage interest. Professor Deborah Geier of Cleveland State University, Cleveland-Marshall College of Law, argues for limits, questions the linkage between current tax benefits and homeownership, and explains why the Panel's recommendations do not sufficiently encourage homeownership by low income taxpayers. Professor Stuart Lazar of Thomas M. Cooley Law School criticizes the Panel for undervaluing the effect on housing costs in many locales, using the 15% credit rate as a disguised means of raising taxes, and not explaining how it determined that the current mortgage deduction results in too little business investment.

—Gail L. Richmond, Fort Lauderdale, FL

### POINT: DESPITE ITS FLAWS, THE PANEL'S PROPOSAL IS A GOOD FIRST STEP

by Deborah A. Geier, Cleveland, OH

#### ON CAPITAL GAINS AND MARGINAL TAX RATES

The key to the Tax Reform Act of 1986, which was a thing of brilliance, was that it raised the capital gains tax rate to equal that imposed on ordinary income. Prior to the 1986 Act, the top ordinary income tax rate (applicable to labor income and investment returns other than capital gains, such as interest, rent, and dividends) was 50%, while the top capital gains rate was 20%. The 1986 Act repealed the special tax preference for capital gains, taxing all income at the same rate. This allowed a radical reduction in the top tax rate to 28% (33% for certain taxpayers) and, because the many spe-

cial rules pertaining to capital gains became entirely irrelevant or much less important to tax planning, resulted in radical tax simplification.

Most capital gains realized by median-earning households are tax-free, such as home sale gain, or tax-deferred, such as capital gains realized in tax-preferred retirement accounts. Thus, increasing the capital gains tax rate to equal that applied to ordinary income affected mainly high-income households that realized taxable capital gains. But those households also benefited mightily from the slashing of the top marginal tax rates. It was a stroke of genius. And the economy steadily expanded.

But, alas, such thinking is anathema to conservatives today, whose fondest wish is to tax only labor income, freeing all capital income (which is concentrated in the wealthiest of households) from tax. The President's Advisory Panel on Tax Reform ("Panel") never considered

taxing all income, whether from labor or capital, at the same rate at the individual level, as under the 1986 Act. Indeed, the Panel recommends further shifting the tax burden from capital to labor income. Its "Growth and Investment Tax Plan" recommends extending the 15% tax rate currently applicable to capital gains and dividends to interest, as well. Its "Simplified Income Tax Plan" recommends that 75% of capital gains be tax-free, reducing the effective rate on those gains to between 3.75% and 8.25%. The top tax rate on ordinary income such as wages, in contrast, would be either 30% or 33%, and the current 10% tax rate would be abolished. The lowest ordinary income tax rate would be 15%. *Panel Report* at 61.

This refusal to entertain returning to the 1986 bargain of taxing all income at the same rate means that overall ordinary income rates need to be higher than would otherwise be the case. This result is unfortunate, as the

inability to further reduce middle-class tax rates as a trade-off for repealing or reducing several middle-class tax deductions means that the Panel's recommendations are doomed. That's a shame, as there is much good in the plans, as well.

### THE MORTGAGE INTEREST DEDUCTION

As just one example, the current deduction for home mortgage interest is estimated to result in individual tax rates that are about 7.5% higher than they otherwise would be without the deduction. But the Panel recommends tightening the tax subsidy without reducing middle-class tax rates. Rather, the revenue raised would pay, in part, for the reduction of taxes on capital income. Reforming the tax subsidy for home mortgage interest is a worthy goal, but without an offsetting reduction in tax rates aimed at the middle class, it will be a hard sell to the American people.

A pure income tax would allow no deductions with respect to homeownership, as the income from the home is not taxed. The purpose of deductions under a pure income tax is to reduce the gross receipts earned from a business or investment to a net profit so that only that profit element is taxed. We do not tax the imputed rental income enjoyed by a homeowner who lives in his residence (rather than renting it out to a tenant), and we generally do not tax gain on the sale of a primary residence. So what is the purpose of the home mortgage interest deduction?

The deduction is an example of a tax expenditure, a provision that has nothing to do with properly measuring "income" in an income tax but rather is a way to implicitly spend money through the Internal Revenue Code and subsidize an activity for social policy reasons. The home mortgage interest deduction is ostensibly aimed at increasing the homeownership rate by subsidizing the borrowing costs to buy a home.

In other words, if the government wants to increase the homeownership rate, it has two options: enact a pure income tax and spend some of the revenue obtained on a targeted program to increase the homeownership rate, or enact an impure income tax that collects less revenue by allowing a tax-reducing subsidy for homeownership. Because of the anathema for direct spending programs in this country, much social policy spending is done through the Code.

If the government chose to spend money directly (by, say, sending a check to people) to increase the homeownership rate, the program would almost certainly be tailored to those lower on the income scale and those attempting to purchase their first home. Using the Code to deliver the subsidy, however, has several perverse effects. First, the deduction fails to help those who don't earn enough to owe tax or to itemize their deductions. Second, a \$1 deduction to someone whose income would otherwise be taxed at 30% saves 30 cents in tax, whereas a \$1 deduction to someone whose income would otherwise be taxed at 10% saves 10 cents. In other words, it's an upside-down subsidy. The Institute on Taxation and Economic Policy estimates that nearly 80% of the benefits from the home mortgage interest and property tax deductions go to the top 20% of taxpayers in terms of income, while only 5% goes to those in the bottom 60% of the income scale, the very taxpayers who may be struggling to own a home. See James R. Hagerly, *Housing Sector Seeks No Tax Remodeling*, WALL ST. J., Jan. 31, 2005, at A2.

Studies show that the deduction does not likely increase the homeownership rate. The benefit of the subsidy has varied dramatically over the last several decades with changes in tax and interest rates, and yet the homeownership rate has remained virtually unchanged (between 65% and 70%). Edward L. Glaeser & Jesse M. Shapiro, *The Benefits of the Home Mortgage Interest Deductions*, in 17

TAX POLICY AND THE ECONOMY 37 (James M. Poterba ed., 2003).

Moreover, homeownership rates in comparable economies, such as those of Canada and Australia, are virtually identical to the U.S. rate, even though no home mortgage interest deductions are allowed. The deduction produces substantial and inefficient windfall losses for the government by rewarding people for engaging in behavior (buying a home) that they likely would have engaged in without the subsidy.

Moreover, economists have long complained about other bad economic effects arising from the home mortgage interest deduction. Studies show that it serves mainly to cause buyers to purchase larger houses than they otherwise would, displacing business investment and other types of investment that have a greater impact on economic growth. See Glaeser & Shapiro, *supra*. Once a house is built and furnished, it just sits there, adding very little to overall economic growth. Economists would much rather see us buy a slightly smaller house and spend our investment dollars on infrastructure, research and development, or entrepreneurial activity that expands the economy in the long run.

The real estate lobby argues that repealing the home mortgage interest deduction would cause a collapse in home prices, because tax subsidies are now built into the price of houses. But Great Britain repealed its home mortgage interest deduction over a 12-year period, ending in 2000, and there was no crash in house prices, which kept rising.

### THE PANEL'S PROPOSAL

Rather than completely repeal the deduction, however, the Panel recommends replacing it with a 15% tax credit. A taxpayer paying \$100 in mortgage interest would credit \$15 of that interest against his tax due, the economic equivalent of deducting that \$100 by someone in the 15% tax bracket. In other words, a taxpayer in the 30% tax bracket would enjoy the same \$15 in tax savings as someone in



the 15% tax bracket, thus eliminating the upside-down nature of the subsidy under current law. In addition, the interest paid on debt above \$227,000 to \$412,000 (depending on geographic location) would not be creditable, thus better targeting the buyer who is on the homeownership margin and eliminating the inefficient economic incentive to buy ever-larger homes in lieu of more productive investments for the economy. The current deduction would be phased out over a period of years.

If the purpose of the subsidy is to increase the homeownership rate, however, an even more efficient proposal would be aimed solely at first-time homebuyers. Nevertheless, the Panel's proposal is a good first step. Unfortunately, without a concomitant reduction in middle-class tax rates (which could be paid for by taxing all income at the same rate at the individual level), it is likely dead on arrival. That's a shame.

## COUNTERPOINT: CURRENT LAW IS A BETTER OPTION

by Stuart Lazar, Rochester, MI

### THE EVOLUTION OF CURRENT DEDUCTION LIMITS

Analyzing any tax reform proposal requires a comparison of the proposal to the ideal—what we think, in a perfect world, should be the correct answer—as well as a comparison to current law to determine whether the reform provides for a better result. The proposal by the Panel to replace the home mortgage interest deduction with a “Home Credit” fails to provide either the correct answer or a better result than the status quo while, at the same time, ignoring the potential impact of such changes on areas of the housing market.

Prior to 1986, individuals could generally deduct all interest they incurred regardless of how they used the borrowed funds. In 1986, Congress placed significant limitations on the deduction of “personal

interest”—defined generally as any interest incurred by an individual other than trade or business interest, investment interest, passive activity interest, qualified residence interest, certain interest on unpaid taxes, and interest on educational loans. Certain limitations apply to the deductibility of interest even in the aforementioned categories.

With respect to qualified residence interest, the Staff of the Joint Committee on Taxation noted in its explanation of the changes made to section 163 (dealing with the deductibility of interest) by the 1986 Act that “[w]hile Congress recognized that the imputed rental value of owner-occupied housing may be a significant source of untaxed income, the Congress nevertheless determined that encouraging homeownership is an important policy goal, achieved in part by providing a deduction for residential mortgage interest.” Staff of Joint Comm. on Tax’n, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, JCS-10-87, at 263-64 (1987). Qualified residence interest, as defined by the 1986 Act, includes both “acquisition indebtedness” (indebtedness secured by a qualified residence that was used to acquire, construct or substantially improve such residence, limited to \$1,000,000) and “home equity indebtedness” (indebtedness secured by a qualified residence and limited to the lesser of \$100,000 or the excess of the fair market value of the residence over the amount of acquisition indebtedness with respect to such residence). A “qualified residence” includes the taxpayer’s principal residence and one other residence. Thus, under current law, interest on a maximum of \$1,100,000 of debt securing the taxpayer’s principal residence and vacation home is deductible.

### THE PANEL MISINTERPRETS CURRENT TAX BENEFITS

The Panel proposes to reduce significantly the benefits currently provided in several ways. First, the amount of indebtedness eligible for

favorable tax treatment would be reduced from \$1,100,000 to an amount based on median area home purchase prices as determined from data provided by the Federal Housing Administration (resulting in limits for eligible indebtedness of between \$227,147 and \$411,704). Second, the current tax deduction would be converted into a tax credit. Finally, only acquisition indebtedness on a taxpayer’s principal residence would be eligible for favorable tax treatment. Interest on home equity indebtedness and any vacation home debt would not be considered in determining the amount of the tax credit.

These Panel proposals would not further Congress’ policy goal of encouraging homeownership and, in fact, the Panel seems to almost disregard the policy goal of homeownership in recommending this proposal. It claims that the Code currently favors investment in housing over other productive expenditures. To support this claim, the Panel cites a study by the Department of the Treasury’s Office of Tax Analysis, which found that the economy-wide tax rate on owner-occupied housing is close to zero, compared to a tax rate of approximately 22% on other forms of business investment. From this, the Panel concludes that “[t]his may result in too little business investment...” *Panel Report* at 71. It is unclear how it came to this conclusion or why it believes that a credit (rather than a deduction) will result in the right amount of business investment. In fact, if Congress has expressed a goal of promoting homeownership, one would expect that the tax rate on such investment would be lower than the tax rate on other types of investment. Raising the effective tax rate on homeownership, following the Panel’s logic, would be a step toward discouraging homeownership.

The Panel also cites, as a reason to change current law, the statistic that the tax incentives for housing are not shared equally among taxpayers. According to the Panel, the majority of the tax benefits currently go to the

minority of taxpayers that itemize deductions—with more than 55% of the tax benefits going to the 12% of taxpayers who had cash income of more than \$100,000 in 2004. *Panel Report* at 72. The Panel believes that converting the current deduction into a tax credit that may be taken regardless of whether a taxpayer itemizes or takes the standard deduction would increase the number of taxpayers able to take advantage of the tax benefit. It has determined that providing a 15% “across-the-board” tax credit rather than a deduction based on a taxpayer’s marginal tax rates would provide for a greater sharing of the tax benefits relating to homeownership.

While the Panel is correct that a greater portion of the tax incentives relating to homeownership are received by those in higher-income groups, it makes the common mistake of analyzing taxes in a vacuum. The Panel fails to take into account non-tax subsidies for those citizens who pay little to no taxes at all. Although such subsidies may not completely erase the gap between benefits provided to the “haves” and the “have-nots,” they may significantly narrow it.

Moreover, while more tax deductions currently go to taxpayers in the higher tax brackets, it is those taxpayers who currently pay a higher share of the income tax. The Panel notes that the top 20% of households earn about 60% of all income and pay about 70.6% of all federal taxes (compared to the bottom 20%, which earn 2% of all income but pay only 0.4% of all federal taxes). *Panel Report* at 30-31. Thus, it is not surprising that taxpayers in the higher tax brackets receive a greater share of the tax benefits.

#### THE PROPOSAL IS A HIDDEN RATE INCREASE

The Panel’s proposal to replace the current tax deduction with a 15% tax

credit is a back-door way of increasing marginal tax rates on higher-income taxpayers. Deductions generally offset income under our current tax system, with the result that income earned and spent on a deductible item results in no additional tax liability. For example, a taxpayer who earns \$200,000 and incurs \$10,000 of deductible expenses is taxed generally at the same rate as a taxpayer who earns \$190,000 with no deductible expenses. Under the Panel’s proposal, a taxpayer in a marginal tax bracket above 15% who earns \$200,000 and incurs \$10,000 of mortgage interest will be taxed at a higher rate than a taxpayer with \$190,000 of taxable income and no interest deduction. Any credible tax reform proposal would work to increase transparency in our system, not cloud the effective tax rate even more.

#### THE PANEL IGNORES ECONOMIC REALITY

Finally, the Panel completely ignores the effect that its proposal will have on the U.S. housing market. It cannot be contested that tax benefits of homeownership are taken into account in a taxpayer’s determination of the homes which she can afford and the price paid for a particular home. If that fact is undisputed, how can the Panel’s proposal not cause a reduction in the value of homes in this country? By using a region’s median housing price to determine the amount of indebtedness eligible for the Home Credit, the Panel is conceding that approximately half of the homes purchased in the region would be affected by the mortgage cap. Whether or not a taxpayer is financing an “expensive” home, the value of that home is affected by the value of more expensive homes in that region. A increase in the after-tax cost of financing, which the proposal would

create, is likely to reduce the value of those homes. A decline in prices for the nation’s most expensive housing stock can only negatively affect the prices of lower cost houses. If, for example, the value of a \$500,000 home drops even 5% (to \$475,000) as a result of the Panel’s proposal, the value of homes previously in the \$400,000-\$475,000 price range must similarly decline in value. This will lead to a corresponding decline in value of homes in all price ranges.

The Panel also fails to account for abnormally high housing prices in such locales as Boston, San Francisco, and New York. Taxpayers in these areas will be seriously affected by the proposed changes. Similar negative consequences will be felt by taxpayers in areas where a large number of homes are sold to vacationers (such as Cape Cod, Massachusetts, Newport, Rhode Island, and Traverse City, Michigan) because purchasers of second homes will not receive any tax benefits under the Panel’s proposal. The Panel’s meager phase-in of these rules over a five-year period for preexisting home mortgages will do little to prevent a decline in housing values. Fair market value is determined, in large part, by what a purchaser is willing to pay—an amount that will almost certainly decrease absent the current tax incentives for homeownership.

The current tax treatment of qualified residence interest is far from perfect. The Panel’s proposal does little, however, to advance Congress’ clearly-stated policy of encouraging homeownership while, at the same time, it will have an almost-certain negative effect on home prices. In today’s uncertain economy, and with interest rates continuing to rise, those whose home is their most valuable asset have much to fear should the Panel’s recommendations come to fruition. ■

# INTERVIEW WITH **GEORGE K. YIN**

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



GEORGE YIN

**Q** You were tax counsel to the Senate Finance Committee from 1983 to 1985. How does the tax writing process today compare with the process during your earlier tenure?

**A** There have been a number of differences in that twenty-year period. There certainly has been an increase in activity. As one small measure of that, the Joint Committee on Taxation in 2003 received almost 5,000 requests for revenue estimates of tax legislative proposals, a roughly ten-fold increase over the number of requests received twenty years ago. I suspect that if you actually counted the number of tax bills filed, or examined other indicators of legislative activity, there would be a comparable increase. All of this is in part attributable to an increasingly complicated society with more problems, and therefore more proposals for tax legislative changes to solve those problems. Furthermore, as the law gets more complex, it feeds on itself so that the more-complicated law generates more proposals for change. So there definitely has been an increase in overall activity. Interestingly, since the number of members of Congress has remained constant during this period, it may mean that the members now devote less time to each proposal than they did twenty years ago.

**INTRODUCTION:** George Yin has been Chief of Staff of the Joint Committee on Taxation since early 2003. He left the staff on November 18, 2005 to return to the University of Virginia School of Law where he will be nominated to become the inaugural Edwin S. Cohen Distinguished Professor of Law and Taxation.

Another very important change is the limited term of the Chairs of the tax-writing Committees. I think that every member of Congress would tell you that there is a very dramatic and significant difference between simply being a senior member of a committee and being the Chair of the committee. The Chair has a tremendous amount of responsibility in terms of overseeing the overall agenda. So if in fact, as we have seen in recent years, there is a greater turnover in the identity of the Chair, because of term limits or other reasons, that change no doubt has had a significant impact on this process. Moreover, when Chairs turn over, their staffs typically turn over as well, and that similarly has an important effect. In general, there are also greater numbers of staff involved in the tax legislative process, both at the committee level and also for each of the individual members of the committee.

One other important fact is that staff salaries continue to be less and less competitive with private sector salaries. This has occurred in part because of the caps that are placed on staff salaries due to the caps on Congressional salaries. This increasing salary differential presumably will mean a greater and greater difference over time between the quality of the people on the outside versus the people working for the Congress.

I will mention just one last difference, which I am sure is familiar to all of your readers. Twenty years ago, I would come back from a day of many meetings and see on my desk a stack of fifty or so pink slips containing telephone messages. Being a fairly conscientious sort, I would go through them and try to figure out which ones I could and should respond to as

quickly as possible. But today, of course, I come back from the same busy day of meetings and have 200 emails in my inbox, with each of the people who sent those messages thinking that I am aware of, and working on, their particular problem. All of a sudden, it becomes that much more important for me to respond to each of those messages as quickly as I can, if only to say, "I haven't looked at your problem yet." Thanks to our new technology, the pace and expectations of the job are completely different. Obviously, we also have blackberries, faxes, cell phones, laptops, and the rest, to help ensure that one is always on the job. I can only imagine how the practice of law has similarly changed over the same twenty-year period.

**Q** You were involved with the proposals and planning leading up to the Tax Reform Act of 1986 and wrote in 1987 on the subject of repeal of the General Utilities doctrine. You foresaw corporate efforts to escape the repeal by using passthroughs. Did you or others foresee that the repeal could lead to "corporate tax shelters" as some have come to call them, and do you believe it has contributed to that phenomenon?

**A** Well, that's a new one for me. I suppose if one thinks of General Utilities repeal as an effort to make the corporate tax base more comprehensive, and tax shelters as an effort to avoid being taxed on that more-comprehensive base, then there might be a link between the two. But, that's like saying that if Congress had only repealed the income tax in 1986, there would not be any income tax shelters today. That would also be true.



I would, however, identify a different aspect of the law that might be contributing to corporate tax shelters and be worth reconsidering. I have never completely understood why corporations are fully taxed on their capital gains from investments in the stock of other companies. That seems somewhat contrary to general principles we have in the income tax system. In my review of corporate tax shelters, some number of them seem to be designed to create capital losses that would be used to offset capital gains from investments in stock in other companies. This, of course, does not justify the shelters at all. Nevertheless, if there is something fundamentally flawed in the taxation of those gains, then maybe that should be examined quite apart from the tax shelter issue.

**Q You have written about corporate integration. In 2003 Congress enacted a weak version of integration in the form of a reduced tax rate on dividends. The Tax Reform Commission has proposed some additional integration. Is this a realistic possibility and in what form do you think it will come?**

**A** Assuming that there continues to be an income tax, the corporate integration issue is most usefully thought of separately for public companies and non-public companies. For public companies, I have long advocated the idea that retaining two opportunities to tax actually makes some degree of sense and that the main thing that should be achieved is to reduce the rates of those taxes so that the overall burden in the corporate sector is not disproportionate to the burden outside of the corporate sector. Now obviously, as you suggest, Congress already took a step in that direction in 2003 by reducing the tax rate on dividends and capital gains. It would seem that the next logical step would be to consider a reduction in the corporate tax rate. This may be a viable option for public companies because even if the corporate tax rate were reduced below the top tax rate for individuals, we do not typically think of individuals using public companies as a vehi-

cle to shelter their income. Thus, reducing the corporate tax rate (and keeping the dividend tax rate reduced) would be a viable way to achieve a form of integration for public companies. To ensure that all corporate-source income is taxed at least once, Congress would need to pair any corporate tax rate reduction with a broadening of the corporate tax base. In addition, integration does not provide any justification for reduced capital gains taxes on investments not involving corporate stock, such as real estate.

For non-public companies, you could not achieve integration in the same way. On the other hand, for non-public companies, you could do something that really would not be viable for public companies, which is to have integration through some kind of passthrough scheme. As you know, in the 1990s David Shakow and I came up with a recommendation to provide a passthrough scheme for all private firms, no matter how organized. In general, we recommended something like a liberalized Subchapter S form of passthrough taxation for private firms that have certain restrictions on their ownership structure. For all other private firms, we recommended that a passthrough result be achieved through a reformed version of Subchapter K. Importantly, private firms would no longer be allowed to use Subchapter C, which would be reserved for public companies.

**Q You have thought a lot about how a consumption tax system could be designed to accommodate the working poor. To what extent are consumption taxes really just “wage taxes,” and do you foresee any real likelihood of either an add on consumption tax or a consumption tax replacing the income tax?**

**A** First, in terms of whether a consumption tax is simply a wage tax, the current literature is fairly clear that that is not the case. A “cash-flow” consumption tax (such as a qualified retirement plan, a 401(k) plan, or a “traditional” IRA) is the same as a wage tax, and they both differ from an income tax, principally in

the taxation of the risk-free return on capital. An income tax taxes that return, but a consumption tax and a wage tax do not. The risk premium, however, and the potential abnormal rents from capital investments are taxed under both an income tax and a cash-flow consumption tax. In contrast, neither is taxed under a wage tax. So a cash-flow consumption tax is not the same as a wage tax. It is also not the same as an income tax. It is somewhere between the two. (A “yield-exempt” consumption tax, such as a Roth IRA, does not reach these additional returns to capital and thus is analogous to a wage tax.)

In terms of the likelihood of adopting a consumption tax in the future, I can envision some incremental changes that would move our current system, which is not a pure income tax, further in the direction of a consumption tax. I can envision two types of changes. One set of changes would be to adopt some further expansion of savings incentives as well as to allow greater expensing of capital investments. In addition, in conjunction with those changes, which presumably would result in some loss of revenue, a second set of changes would be to tax consumption more comprehensively than we do today. In the current system, we tax neither savings nor consumption fully. While consumption tax advocates might applaud the former result, there seems to be little justification for the latter. Both income tax and consumption tax advocates should be able to agree that at least consumption should be taxed comprehensively. That would be a useful first step for any tax reform.

One worry about any incremental move towards a consumption tax is the appropriate taxation of debt. At least in theory, in a proper consumption tax, increases in debt should be included in the tax base and decreases of debt should reduce it. Under current law, we do not include increases in debt in the tax base. If we continue that treatment of debt yet move closer and closer to a consumption tax base in other ways, we can quickly achieve a system that is totally irrational and would raise an insufficient amount of revenue.

**Q Do you view the combination of penalty and disclosure reform that the Congress and the IRS have aimed at the more recent tax shelters as having been as effective as the 1986 legislative changes aimed at individual tax shelters, and if not what could be done better?**

**A** I do not view the penalty and disclosure changes that have been made in recent years as having been anywhere near as effective as the 1986 changes in combating tax shelters. The 1986 changes, the principal one being enactment of the passive activity loss rule, essentially ended a whole category of shelters. I do not think anything that has been done in recent years has been anywhere near as effective as that.

In terms of what could be done, if we are serious about wanting to create constraints on tax shelter activity, obviously the 1986 experience provides a model for what further steps might be appropriate. It certainly is the case that that model has not gone overlooked by people either inside or outside of the government. The difficulty is trying to figure out what kind of rule analogous to section 469 could be adopted today. The shelters of twenty years ago, even though they were very extensive and problematic, were often of a similar type. One could then craft a rule like section 469 that in a rough way challenged that whole category of tax shelter.

In today's world, the shelters are more complicated. They do not necessarily have the same pattern and focus. Coming up with an appropriate rule to address them is difficult, to say the least. A rule that attempts to curb today's shelters is likely to be both too broad and too narrow. An alternative approach is to elaborate a bit more on the meaning of an anti-tax avoidance standard that might be available to combat a shelter after the fact. The advantage of such a course is that it wouldn't be necessary to achieve the same degree of precision as a section 469-type rule in exactly hitting only the targeted transactions. All a heightened anti-tax avoidance standard does is to say that a particular transaction is

suspect and needs to be examined further by someone else, presumably by a court. Thus, the degree of precision in identifying the affected transaction upfront does not have to be as great.

As you probably know, in January 2005, the Joint Committee staff laid out an option to address tax shelters by clarifying the meaning of the economic substance doctrine in a targeted way. The proposal identifies up front five or six categories of transactions having the characteristics of tax shelters, and provides that those transactions are subject to a somewhat higher level of scrutiny by a court. The proposal does not say that any taxpayer with such a transaction will not have its tax position respected. Furthermore, it does not specify how the transaction should be taxed if the taxpayer's position is not respected. All it says is that the taxpayer is forewarned that such transactions are suspect and will deserve some higher degree of scrutiny down the road. Obviously, the hope is that the proposal would help to deter some tax shelter activity.

**Q What is the status of that issuance by the Joint Committee?**

**A** It was a set of options that we put together in response to a request from the Chairman and Ranking Member of the Senate Finance Committee. The request was to suggest options to improve tax compliance and reform tax expenditures. We put together a report with about seventy or seventy-five specific recommendations, one of which related to the tax shelter issue I just mentioned.

**Q Has anyone acted on any of those recommendations in any public way?**

**A** Well, a relatively small item has actually already been enacted into law. Others have been considered and included in bills approved by the tax-writing committees. There also have been hearings on some of the proposals. The process obviously takes a while. I assume that the menu of ideas put together by the staff will

continue to be relevant to the Congress for some time to come.

**Q Please describe the legislative process leading up to the 2004 JOBS Act in terms of (1) level of lobbying activity, (2) involvement of the Treasury, and (3) involvement of the IRS in technical drafting and planning for implementation.**

**A** There was a lot of lobbying activity. In terms of how the level of activity compared to that in prior periods, my assumption is that lobbying has probably increased, although that issue could be examined empirically. One difficulty in researching this is identifying the appropriate metric to measure and compare the level of activity. Obviously, larger and more complicated bills with complex and potentially significant provisions are going to engender more private-sector interest than simpler, more straightforward bills. It would be necessary to find a prior bill that in some sense is "comparable" to the JOBS bill in order to compare the amount of lobbying activity.

Involvement of the Treasury is an interesting question. On some issues, such as a Senate Finance Committee proposal to clarify the economic substance doctrine in a comprehensive way, Treasury's influence was quite apparent. Treasury opposed the idea, as did many people in the private sector. Without any government support and with ample outside opposition, it was quite clear that that proposal was not going to be enacted into law.

On the other hand, Treasury also opposed other provisions that did make it into the law. Two examples are the repatriation proposal and the manufacturing deduction, both important components of the JOBS bill. The Treasury was strongly opposed to both, with the rumor that the President himself had been critical of the repatriation provision, yet that opposition did not deter their enactment. From that experience, one might conclude that Treasury's influence was not very great in 2004. Now whether their influence was less than what it was in

1986 or earlier times, other people are going to have to figure that out.

In terms of involvement of the IRS, it has always been somewhat of a bone of contention as to how much and how early the IRS should be involved in the legislative process. At some level, I think all who are part of the process understand the importance and the advantage of involving at an early stage those persons who will be responsible for actually carrying out the various provisions, should they be enacted into law. On the other hand, the concerns of the IRS should to some extent be represented by the policy office of the Treasury Department. Furthermore, if the legislative process is a contentious one—and aren't they all—proponents of the legislation will place a premium on minimizing the number of people involved in the process at all stages, particularly the early stages. That means that a lot of people often are cut out of the process who probably should be involved. This reality applies not just to IRS personnel, but certainly includes them.

**Q We have seen an increasing number of businesses that choose to operate as S corporations. What is your view of these developments as a policy matter?**

**A** Well, I hope it does not reflect some type of abuse that would require a major revision of Subchapter S. After a number of years of study, I am convinced that the S corporation regime is quite a sensible way to achieve a form of integration for private companies. There are certain keys to making the regime work correctly. The most important key is the limit it places on who can be an owner of an S corporation. The theory of this limit is very straightforward—as long as the owners of a passthrough are more or less in the same tax situation, a whole lot of problems that we see addressed in great detail in Subchapter K can be avoided. This is because we just do not care very much about how the various owners share the tax items of the corporation. But as soon as there is deviation from that general principle, there is the need to create something like

Subchapter K, a much, much more complicated and (in my view) less desirable passthrough regime.

The neat thing about Subchapter S is that intentionally or unintentionally, it contains ownership restrictions which more or less achieve the necessary policy condition. One restriction is to prohibit tax-exempt and foreign owners or, in the case of tax-exempts, ensure that their share of the entity's income is taxable to them. The other is to prohibit corporate owners of an S corporation. The reason corporate owners are problematic is that some corporations have large pools of losses and therefore are effectively tax exempt to the extent of such losses. By eliminating these two categories of owners, we are left with S corporations whose owners are taxed pretty much alike. In that world, we can have quite a simple and straightforward method of taxing the income of the business only once.

**Q Please describe the process by which the Joint Committee staff reviews large refund claims and what happens when the staff and the IRS disagree.**

**A** Under the law, the Joint Committee has jurisdiction to review any proposed refund in excess of \$2 million. The law does not specifically grant any authority to the Joint Committee beyond that. That is to say, the Joint Committee must have an opportunity to review such proposed refunds, but has no ability, for example, to stop any refund with which it may disagree. The process that the Joint Committee and the IRS carry out is a collegial one. The Service provides to the Joint Committee a file on all proposed refunds in excess of \$2 million, and we try to review them expeditiously. We offer little or no comment on many of the proposed refunds. For some, we point out some error that may affect the refund in some way. In a few instances, we raise a more serious objection. It is really then up to the Service to determine whether any particular action should be taken in response to our objection. Over the years, we have

maintained a very good relationship with the IRS and I believe they take our concerns seriously.

The Joint Committee's refund review jurisdiction also benefits its legislative responsibilities. The staff has a little window to observe how the tax law is being administered, and some of those observations lead to legislative proposals to change the law.

**Q Are there any statistics on how often the IRS agrees or disagrees with a negative reaction by the Committee as to a particular refund?**

**A** I am not aware of any.

**Q Are you aware of any effort in Congress at any point to give the Joint Committee something more like a veto power over refund claims?**

**A** I am not aware of anything like that, and I frankly do not think it would be a good idea. A veto power would obviously put a lot more responsibility on the work that we do and the decisions that we make. We frankly are just not set up for being a comprehensive reviewer of all large IRS refund claims. I have three attorneys who do essentially all of our refund review work. If you compare that to the hundreds or maybe thousands of people at the IRS who are processing these various claims all the way through from beginning to end, we could not begin to give the same degree of attention to each of those cases that the IRS provides. The IRS is the administrative agency. There has to be some deference to their judgment and their ability to carry out the basic tasks. What this provision does is to give Congress a little window to monitor what is going on. A veto power is not necessary to serve this purpose. ■



# SPECIAL REPORT:

## MONEY LAUNDERING LEGISLATION IN THE U.K.

THE U.K.'S ROLE AS INTERNATIONAL ENFORCEMENT OFFICER

by Richard Palmer, London, England

**INTRODUCTION:** On Wednesday, March 22, 2006, at 1:00 pm ET, the Tax Section together with ABA-CLE will sponsor its annual **Tax Link Live** member benefit teleconference. This special 90-minute ethics program will feature a discussion on **"Ethical Considerations for a U.S. Practitioner in Planning for a U.S. Multinational Client."** Speakers will include: Joan C. Arnold, Pepper Hamilton LLP, Philadelphia, PA; Peter M. Cohen, Trident Trust, Atlanta, GA; Richard Palmer, Ashurst, London, England; H. David Rosenbloom, Caplin & Drysdale, Washington, DC, and Stanley C. Ruchelman, The Ruchelman Law Firm, New York, NY. This expert panel will discuss the U.S. practitioner's ethical considerations in planning for a U.S. multinational client when confronted with fraudulent avoidance of foreign law and examine whether US ethical principles may conflict with foreign rules. The panel also will explain the "Know Your Customer" (KYC) rules that are applicable to practitioners in the U.K., especially in light of the broad definition of money laundering that includes assisting persons who have committed tax fraud in another country and KYC requirements that apply to the offshore sector in response to the OECD challenge initiated several years ago. The following article is part of the program materials for the teleconference. For details on registering and obtaining CLE ethics credit, please see the ad on page 23 immediately following this Report.

**M**oney laundering is the process by which the identity and ownership of the proceeds of crime are concealed so that the proceeds appear to originate from a legitimate source and can be retained permanently or recycled into further criminal enterprises. The scope of money laundering laws has broadened significantly over the last couple of years for four reasons. First is due to the second Money Laundering Directive and secondly, and crucially, the tracing of Islamic terrorist funds has become a very high priority for law enforcement agencies all over the world. Thirdly, the Government sees the Proceeds of Crime Act 2002 ("POCA") as one of the key weapons in its armoury against criminal conduct. Fourthly, the police in the U.K. get to keep 50% of the recovered proceeds (but not in relation to evasion of foreign taxes where that is the crime).

Whilst the U.K. money laundering legislation applies principally to U.K. businesses and their U.K. advisers, advisers based outside the U.K. should be aware of the basic rules and reporting requirements for a number of reasons. If U.K. advice is required on any transaction, then the advisers (or their

client) will need to provide sufficient proof of their identity (for example, copies of passports) to enable the U.K. adviser to meet its obligations to comply with formal identification procedures. In addition, the U.K. money laundering legislation is very widely drafted and (as discussed below) may require reporting of transactions which do not constitute criminal conduct where they are carried out but which would be criminal in the U.K. U.S. advisers should be aware that U.K. advisers may be obligated to report both their client and any overseas adviser engaged on any transaction which is reportable. The U.K. adviser is also prohibited from telling the US adviser or client that he has reported them. If a disclosure is made in respect of, say, foreign tax evasion, the U.K. revenue authorities have procedures for passing on details of any such disclosure to their counterparts in other jurisdictions.

The U.K. has, therefore, moved well ahead of its European colleagues in the scope and enforcement of its anti-money laundering laws. The two main sources of law in the U.K. are POCA and the Money Laundering Regulations 2003. The former has

been supplemented by the Serious Organised Crimes and Police Act 2005 which provides a significant increase in the powers available to HM Revenue and Customs investigators.

### POCA

The POCA establishes extremely broad powers in relation to the proceeds of crime, including the power to freeze assets, trace and seize assets, and make confiscation orders, but it goes further than this. It creates offences that enable those who facilitate money laundering to be prosecuted and it expands the scope of the crimes covered.

There are two different types of powers that are provided for. One is effectively a broad tracing type of power where the authorities go in and say "We know you nicked this money and bought this yacht with it so therefore we are going to take this yacht from you". The second power is akin to confiscation orders which derive after a person is convicted. In this case the court says "You've got no visible means of support, you're living a criminal lifestyle, we know you've been dealing in drugs, we believe that you

have made about £3m out of this illegal activity so you must pay us £3m and if you don't come up with the money then you'll serve extra time in prison".

But what does it mean for the tax practitioner and the lawyer? Well here the legislation establishes a series of money laundering offences some of which apply to both the regulated and unregulated sectors and some of which apply only to the regulated sector. The Money Laundering Regulations set out what businesses are within the regulated sector and these include businesses engaged in insolvency, tax, accountancy and legal services.

## CRIMINAL PROPERTY AND CRIMINAL CONDUCT

The concept of criminal property is at the heart of money laundering law. It is a concept on which the POCA operates and it is very important to realise that the law on money laundering has moved beyond merely policing the proceeds of drug and terrorist offences and now is a very wide-ranging law indeed.

The starting point is the definition of criminal property which is contained within section 340 of POCA. Criminal property is property which constitutes a person's benefit from criminal conduct or represents a benefit either in whole or in part directly or indirectly. You cannot get much wider than that. In the typical tax evasion case, property will have been obtained as a result, say, of legitimate trading or disposal and a portion of it retained as a result of the non-payment of tax. The alleged offender has to know or suspect that it represents such a benefit but as this is very broad indeed the next question is what is criminal conduct?

Criminal conduct is defined in section 340(2) of POCA as conduct which constitutes an offence in any part of the United Kingdom (we would expect that) or (and this is the really shocking part) "would constitute an offence in any part of the United Kingdom if it occurred there". You don't need to have knowledge of the

criminal law of any other country and, therefore, the place where the criminal conduct occurred is irrelevant. What matters is whether the conduct would have constituted an offence if it had been committed in the U.K. It is not clear whether you simply transpose the facts or consider the facts in the context of the relevant circumstances. This is what is known as the single criminality test. The conduct need not be unlawful in the place where it occurs but only in the "home" jurisdiction. Whilst this has the benefit of simplicity it can produce absurd results—viz the Spanish matador and the U.K. road haulier. It also means that many more U.K. disclosures are being made in circumstances where perhaps they shouldn't.

The more sensible interpretation, but one that is not technically correct, is the dual criminality test—namely the criminal conduct must be criminal in both the state of commission and the U.K., but that then means you need to know the criminal law of the foreign country. Further, it is immaterial whether the conduct occurred before or after the POCA came into force. This is a retrospective law which is pretty rare in constitutional terms under U.K. law. We'll come to what sort of tax offences are caught by criminal conduct shortly but in the meantime it is worth looking at the actual offences which POCA sets out and which could apply to advisers.

## PRINCIPAL OFFENCES

There are three principal offences which apply to both the regulated and unregulated sector and they are set out in sections 327, 328 and 329 of POCA. It is worth noting that section 328 is particularly widely drafted and includes entering into or becoming concerned with an arrangement which a person knows or suspects (this is actual knowledge or an actual suspicion), facilitates the acquisition, retention, use or control of criminal property by or on behalf of another person. When providing tax advice, for example on property transactions, setting up trusts or creating offshore

structures a lawyer/tax adviser should be aware of the need to consider whether the transaction on which he is advising facilitates the acquisition, retention or use of criminal property. If you go further and acquire, use or have possession of criminal property then you are also guilty of a criminal offence and in all these cases the maximum penalty is 14 years in prison. It should be pointed out that no offence is committed if you do not have actual knowledge or suspicion that the property represents a benefit from criminal conduct. Suspicion requires a degree of satisfaction (not necessarily belief) extending beyond mere speculation as to whether something has occurred or not. It is more than simply having a cause for concern. In that case you should ask the client more questions which may allay concerns, but that isn't always easy.

## TAX EVASION AND AVOIDANCE

The question of whether or not fiscal offences and in particular evasion of foreign tax can be regarded as predicate offences for the purposes of U.K. anti-money laundering law has been much debated. Some commentators take the view that they are not, relying on the long-standing principle that the courts of one country will not enforce the revenue and penal laws of another. To apply the money laundering laws to foreign tax evasion would be to indirectly circumvent this rule and enforce foreign revenue laws. Furthermore, they point to the fact that the FATF (Financial Actions Task Force) makes no mention of fiscal offences as predicate offences in its Recommendations. This argument ignores the fact that U.K. parliament can make laws which derogate from this long-standing principle and provisions of tax treaties which allow for exchange of information. Much of the U.K.'s money laundering legislation is about collection of information which it is known will be shared between law enforcement agencies. If the matter came to the courts, the likely answer is that the court would uphold the POCA rather

than the common law principle. In short, if the foreign conduct amounts to what would be tax evasion in the U.K. (or a similar criminal offence such as cheating the Revenue) the U.K.'s anti-money laundering provisions will apply.

Tax evasion is a criminal offence in the U.K. and the financial benefit gained represents a person's benefit from criminal conduct even if the money or property on which tax should have been paid was legitimately earned. It is difficult to establish clear guidelines as to the difference between tax evasion and tax avoidance save that the consequences of the former are criminal convictions and the latter civil penalties. In essence though, tax avoidance is perhaps taking advantage of the fact that the tax system is not always joined up whereas tax evasion is really the illegal non-payment of tax rightfully due. The common thread in all cases of direct tax evasion is concealment or dishonesty. The distinction has not been helped by courts and judges often using the terms interchangeably, and occasionally embellishing them with phrases such as "unacceptable tax avoidance" or "innocent evasion". To the extent that the Revenue has any consistent practice it has indicated that there will be no criminal offence where there is no element of concealment of the true facts of arrangements for which there is a respectable technical case. A key question though is what level of disclosure is required to ensure there is honesty. It will be interesting to see whether a taxpayer who has entered into a tax avoidance scheme which he has not disclosed under the Tax Avoidance Disclosure Regulations and which is successfully challenged by the Revenue will face a criminal charge. Will such taxpayers find that although they haven't disclosed under the Disclosure Regulations their advisers have reported them under POCA?

In the U.K. at least, there is now a statutory offence of fraudulent evasion of tax in section 144 FA 2000 but, historically, tax evasion has been charged

as the common law offence of cheating the Revenue. In both offences, dishonesty must be proved. It is interesting to note that for indirect tax (such as VAT) a criminal offence can be committed as a result of an innocent or accidental error.

## PRIVILEGE AND CONFIDENTIALITY

A solicitor is under a professional and legal obligation to keep the affairs of clients confidential and that protection is provided by way of a privilege against disclosure.

This is a fundamental cornerstone of the legal system. But not everything that a lawyer has a duty to keep confidential is privileged. Only those confidential communications falling under the head "advice privilege" or "litigation privilege" are protected. In the current context it is advice privilege which will be relevant. That relates to communications between a lawyer acting in his capacity as a lawyer and a client if they are confidential and for the purpose of seeking legal advice from a lawyer or providing legal advice to a client. It is therefore only those communications that directly seek or provide advice which are privileged.

Legal professional privilege does not, however, exist in respect of documents which themselves form part of a criminal or fraudulent act or communications which take place in order to obtain advice with the intention of carrying out an offence. So, with regard to the principal offences, namely concealment, arrangement, acquisition, use, or possession, if the solicitor knows that the transaction on which he is acting will constitute a principal offence, not only does the solicitor risk committing such an offence (unless he makes an authorised disclosure) but the communications relating to the transaction are not privileged and can be disclosed.

Even if you suspect that a money laundering offence may be committed statute (POCA §338(4)) clearly states that an authorised disclosure does not

breach any restriction on disclosure or the duty of confidentiality. That is true also where the solicitor receives information about another person (other than his client) whom he suspects is engaged in money laundering. Again the solicitor can make a suspicious activity report without breaching his professional obligations.

## DEFENCES TO PRINCIPAL OFFENCES

It is a defence to the principal offences if a suspicious activity report has been filed with the National Criminal Intelligence Service (NCIS). If the report is made before completion of the suspicious transaction (ie. before any concealing, arranging or acquiring takes place) then the law enforcement agencies have a time period in which to provide or refuse appropriate consent. A solicitor should not take any further steps, having made a report, until he has either obtained NCIS consent or seven days have elapsed. A fast-track system has been put in place for urgent requests and consents can be faxed within 24 hours. This can still, however, leave solicitors in a difficult position. A report that concerns evasion of U.K. tax or NIC's and which is not linked to wider criminality will be forwarded by NCIS to the Inland Revenue and any enquiries they carry out will be in the same manner as any other enquiry. Proceeding with the transaction without appropriate consent can lead to criminal liability. Where the report concerns foreign tax evasion, U.K. tax legislation includes the authority for the Revenue to exchange information with other fiscal authorities. The legislation refers to "the exchange of information necessary for carrying out the domestic laws of the U.K. ... including, in particular, provisions about the prevention of fiscal evasion ...". These exchanges are supported by the extensive network of double tax agreements which often contain specific clauses relating to information exchange. Within the EU, further assistance is available to the respective revenue authorities under the Mutual



Assistance Directive. This process enables one EU country to ask another to use its domestic formal information powers to assist in an investigation. In addition, there are also two new programmes, *Fiscalis 2007* and *Customs 2007* which are designed to counter cross-border tax fraud by implementing improved electronic systems for information exchange, co-operation in investigations and the exchange of information between administrations. In the U.K. it is clear that the Government's objective is to attack tax fraud and evasion by exchange of information rather than supporting any network of withholding taxes. It is also worth noting that the introduction of the Anti-Terrorism Crime and Security Act 2001 allows the Revenue to breach taxpayer confidentiality under certain circumstances which include any criminal investigation or criminal proceedings whether in the U.K. or abroad.

## REGULATED SECTOR — SECONDARY OFFENCES

If you are in the regulated sector then there are some "failure to disclose" offences. The first one is the failure to disclose knowledge or suspicion (actual or constructive) of money laundering to your firm's money laundering officer or to the NCIS. This applies to any employee in the regulated sector. Under the Money Laundering Regulations, all firms within a regulated sector must have a money laundering officer.

In relation to regulated sector offences actual knowledge and actual suspicion are certainly grounds upon which you might be committing a money laundering offence but the legislation also includes circumstances where you have reasonable grounds for knowing or suspecting that a person is involved in money laundering. Section 330 provides that it is an offence to fail to make the required disclosure when in the course of business in the regulated sector a person acquires knowledge or suspicion or there are reasonable grounds for knowledge or suspicion that another

person is engaged in money laundering. In other words, the POCA imposes an objective test and that is because a higher standard is expected in the regulated sector. If a reasonable person in your position would have come to the conclusion that a person was involved in money laundering, the fact that you did not happen to spot it is no defence. This means that you can effectively commit this offence negligently. But what if you suspect that your client might commit an offence? An intention on the part of a client not to pay tax of itself is insufficient to amount to criminal conduct. But does the position change if he makes up his mind and decides not to include certain points on his tax return or do you need to wait until he files the misleading tax return or the deadline date has passed? These questions are important because they affect anyone who might be holding such proceeds/profit (a principal offence under section 328) or any adviser in the regulated sector who would be concerned about failing to report an offence. It is not clear. But what is clear is that you, as an adviser, might want to think twice before asking your client any questions, the answers to which would suggest he has or is committing an offence. It is also unclear whether it is enough to be suspicious in a general sense (what we would call the 'smell test') without any reference to the specifics of the tax scheme. In relation to foreign tax evasion or avoidance, schemes can often be complex so how would an adviser know or suspect if something is merely complex tax avoidance or is illegal tax evasion? Interestingly the Chartered Institute of Taxation's guidance notes give no indication as to what degree of knowledge, if any, a tax adviser is required to have of overseas tax systems. What is helpful, however, to the lawyer at least (but not the tax adviser who is only an accountant), is that if the information which gives rise to the suspicion is privileged then no disclosure needs to be made. One should note that many lawyers rely on this as a defence. Of course, as previously discussed, that cannot apply if the information was commu-

nicated with the intention of furthering a criminal purpose.

There is also a similar offence where the nominated money laundering officer fails to report suspicions to NCIS as soon as practical after he himself is informed.

In addition, there is an offence of tipping-off, that is tipping-off a person about an investigation being started or currently under way. Thus if you know or even suspect that a disclosure has been made you cannot go around telling people that they are the subject of an investigation or allow them to have information which leads them to that conclusion. As a lawyer you may want to make preliminary enquiries of a client or raise questions during a transaction to clarify various issues or to remove any suspicions. Nothing here prevents you from doing that and these enquiries will not amount to tipping off unless you know or suspect that a report has been made and you make enquiries in such a way which discloses those facts.

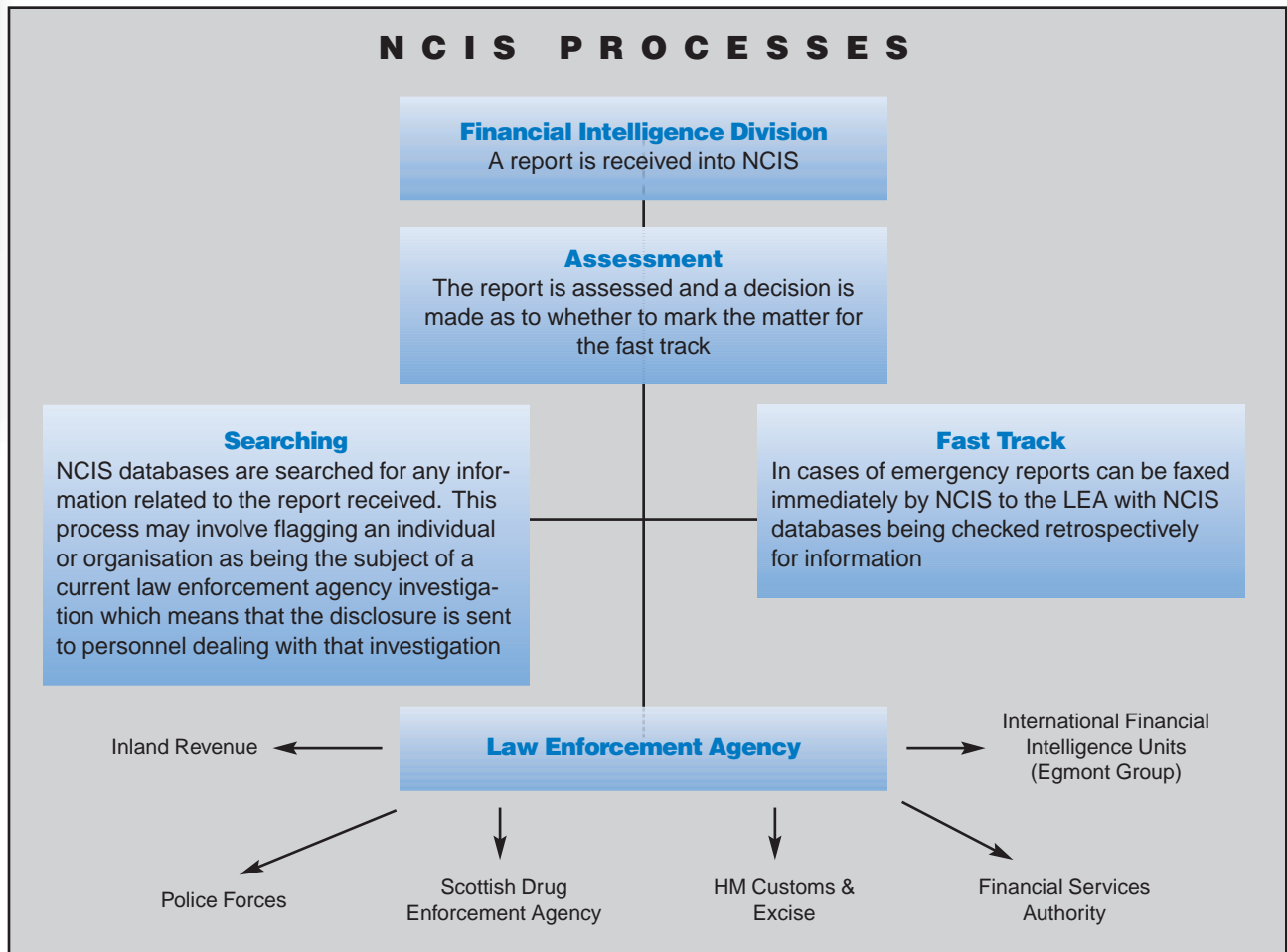
## NCIS

Where a pre-transaction report is made to the NCIS, the solicitor must wait for NCIS consent or for the time limit to expire before proceeding with the transaction. The solicitor should separately determine whether to continue to act but will need to be careful that terminating the retainer does not amount to tipping off. Therefore, the manner in which the retainer is terminated will be important. If NCIS refuse consent then the solicitor cannot take any further steps for 31 days.

In very limited circumstances a legal advisor, having made an authorised disclosure, can tell others of that fact provided that it is necessary and appropriate in connection with the giving of legal advice (*P v. P* 2003 EWHC 2260). (See *NCIS Process illustration next page.*)

## THE MONEY LAUNDERING REGULATIONS

The Money Laundering Regulations and the Joint Money Laundering Steering Group Guidance



Notes, which supplement those regulations and are in effect a “best practice,” set out a number of obligations on relevant businesses. In essence they impose:

- (i) identification procedures;
- (ii) record-keeping procedures;
- (iii) internal reporting procedures; and
- (iv) money laundering awareness training.

Failure to comply with these obligations is a criminal offence.

Identification procedures must be followed where the client and the applicant for business form or agree to form a business relationship, where a payment of €15,000 or more is to be made by the applicant for business or where you, as the regulated business, know or suspect that the transaction involves money laundering whatever the amount.

The client identification procedures are perhaps the most significant part of the Money Laundering Regulations. Your identification procedures must require that as soon as reasonably practicable after contact is first made with the applicant for business that he produces satisfactory evidence of his identity. The test for satisfactory evidence is two-fold. First an initial objective test of what is reasonable and then the objective part of whether the lawyer/regulated adviser is satisfied. This should include copies of passports or identity cards and utility bills and physical inspection by the lawyer. It is worth noting that if satisfactory evidence cannot be obtained the business relationship must stop, otherwise a criminal offence is being committed. Potential clients need to understand that this inconvenience is necessary in the context of fighting money laundering.

As far as record-keeping obligations are concerned, you will need to keep a copy of evidence obtained for a five year period and detail all transactions carried out in the course of your acting for the client.

You will need to comply with internal reporting procedures which means nominating a money laundering officer (MLO) to receive disclosures from staff and who must then also determine whether the information received gives rise to knowledge, suspicion or reasonable grounds for knowledge or suspicion and whether a suspicious activity report should be made to NCIS. The nominated MLO is not a role actively cherished by many lawyers in a firm.

Finally, you must conduct anti-money laundering training with staff which must cover money laundering law and guidance on how to recognise and deal with transactions which may amount to money laundering. ■



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## FROM THE CHAIR

FROM PAGE 4

George Yin, who recently stepped down as chief of staff of the Joint Committee on Taxation and is currently on the faculty of the University of Virginia Law School, will be the keynote speaker at the meeting. There

will be free Volunteer Income Tax Assistance (VITA) training on site; a series of Low Income Taxpayer Clinic programs will be available; the new (2006-2007) John S. Nolan Fellows will be announced as will the recipi-

ent of the Section's Pro Bono Award; and the final rounds of the Law Student Tax Challenge for JD candidates and, for the first time, LLM candidates, will be conducted. ■



# SPOTLIGHT ON COMMITTEES: COURT PROCEDURE AND PRACTICE

by Mary A. McNulty, Dallas, TX

The Court Procedure and Practice Committee (the “Committee”) focuses on procedural and practice issues arising in tax litigation. The Committee has a long history of active participation by members of the United States Tax Court, the United States Court of Federal Claims, the Office of Chief Counsel of the Internal Revenue Service, and the Tax Division of the Department of Justice. This governmental participation creates a unique environment in which issues are considered from a variety of different perspectives, thereby enhancing the tax system.

**CLE Programs.** The Committee offers exceptional CLE programs on procedural issues and hot topics involving tax controversies. Our programs typically include panels moderated by a subcommittee chair and featuring renowned experts, top government officials, and Tax Court or other judges. These presentations are supplemented by reports from the Chief Judge of the United States Tax Court, the Chief Judge of the United States Court of Federal Claims, a representative from the Office of Chief Counsel of the Internal Revenue Service, and the Assistant Attorney General for the Tax Division of the United States Department of Justice.

Our Current Developments Subcommittee Chair also presents a brief report on hot topics relevant to our audience. In addition, at our May meeting, we honor a former Tax Court judge and briefly profile his or her career and contributions to the tax system. We also have a joint luncheon at each of our meetings with the Administrative Practice Committee, featuring a government speaker.

On January 25, 2006, the Committee is presenting the Tax Section’s “last Wednesday” teleconference. The topic is “Fundamentals of Partnership Proceedings – Avoiding Common Procedural Pitfalls,” which is very timely for any practitioner handling a tax shelter case. This topic will also be beneficial to any practitioner handling partnership audits, which have become increasingly common.

At the Tax Section meeting on February 3, 2006, our Committee will be presenting panels on FAS 109 and the Continued Erosion of Privilege, Tax Shelter Litigation in the Court of Federal Claims and District Courts, and Publicity in Litigated Tax Cases. We invite you to join us.

**Comment Projects.** Committee members meet informally with Government representatives on particular issues and make formal submissions on proposed legislation, proposed regulations, and rule changes. The Committee recently provided comments on the Tax Court’s proposed rule changes; considered whether to recommend any changes to the rules of the U.S. Court of Federal Claims as part of a project of that court’s Bar Association; assisted with comments regarding the allocation of a dependency exemption between parents of a common child, due to the potential for increased Tax Court litigation of family law matters; and assisted with comments on proposed Treasury regulations regarding collection due process. The Committee also continues to provide input on the proposed “whistle-blower” legislation, the Tax Court’s e-filing initiative, and ways in which a

taxpayer’s privacy can be protected in Tax Court filings.

Comments are made available to Section membership on the Tax Section’s website by clicking through to either the Committee’s webpage or the Public Policy webpage.

**Leadership and Participation.** The Committee is fortunate to have talented, diverse, and energetic leadership and hard-working members who provide the Committee with experience, creativity, and common sense. Every effort is made to spread responsibility and credit freely. Many have participated in Committee activities for a number of years; others are new to the Committee. We maintain an environment in which new members feel welcome and are encouraged to participate actively.

Each Saturday morning during the Tax Section meetings, our Committee’s officers, sub-committee chairs, and other interested persons meet to plan future meetings. Despite an early start (7:45 a.m.), these meetings are stimulating, productive, and fun. Anyone showing up with a good idea and a willingness to work is likely to be asked to participate in a presentation at a future meeting.

If you would like to become involved with the Committee’s work, please feel free to contact either Mary McNulty (Chair), the Committee’s Vice-Chairs, Larry Hill and Chris Rizek, or the Committee’s Subcommittee Chair for Membership and our Young Lawyers’ liaison, Nicole Bielawski. Better yet—attend our Saturday morning planning meeting at the next Tax Section meeting! ■

# PRO BONO NEWS

by Diana Leyden, Hartford, CT

## VITA DEVELOPMENTS

Since 2003, the Pro Bono Committee has spearheaded an organized effort to entice Tax Section members to volunteer as tax return preparers at volunteer income tax assistance (VITA) sites. Over the last five years, community organizations have mobilized to help taxpayers who qualify for the earned income tax credit (EITC) obtain free, quality tax return preparation. The EITC has been responsible for lifting millions of taxpayers, and their children, from poverty. Free tax preparation assures that these taxpayers get the full benefit of the credit, without having to spend any portion of it for return preparation. The elderly and disabled also benefit from free tax preparation by trusted, well trained volunteers.

The response of members has been tremendous. Training has evolved from a cumbersome mandatory classroom module to an easy, on-line tutorial prepared by the IRS and accessed through the IRS web page <http://www.irs.gov/app/vita/index.jsp>. Volunteers can take the test, known as

“Link and Learn”, at their leisure. After passing the test, the volunteer can simply print out a certificate to present to a site coordinator.

Last year the number of volunteers outpaced the number of volunteer opportunities. To address this, the Pro Bono Committee has joined with the American Association of Retired Persons (AARP), the National Community Tax Coalition, and the Annie E. Casey Foundation to make it easy for trained volunteers to find a contact person in their locality or state and sign up. It is still not too late to help. To find out how to get certified or how to volunteer at sites, go to the Pro Bono Committee web page <http://www.abanet.org/tax/groups/home.html> and click on Pro Bono.

## EFFECTIVELY REPRESENTING YOUR CLIENT BEFORE THE “NEW” IRS: Committee to Oversee Publication of Future Editions

During its meeting in San Francisco, Council made a commitment to fund the publication of a

Fourth Edition of *EFFECTIVELY REPRESENTING YOUR CLIENT BEFORE THE “NEW” IRS*. In addition, Council accepted the recommendations of Karen L. Hawkins, Vice-Chair of the Committee, that it lodge oversight for the publication with the Pro Bono Committee and select an editorial staff comprised of staff attorney, (Sara Spodick), and a faculty advisor, (Mary Ferrari, of the Tax Clinic at Quinnipiac University School of Law). The editors will report or otherwise be accountable to a designated member, or subcommittee, of the Pro Bono Committee. The Pro Bono Committee will also assume responsibility for identifying practitioners from the Section who will volunteer to prepare the “Practice Tips” portion of each chapter—an invaluable feature of the current publication. The Committee is soliciting its membership (and that of the rest of the Section) for this very important task. Volunteers for “Practice Tips” contributions should contact Karen L. Hawkins, at [klhawkins@tagghawk.com](mailto:klhawkins@tagghawk.com). ■

# GOVERNMENT SUBMISSIONS BOXSCORE

Since December 2005, the Tax Section has coordinated the following government submissions, which can be viewed and downloaded free of charge from the Section’s website at [www.abanet.org/tax/pubpolicy](http://www.abanet.org/tax/pubpolicy).

## TECHNICAL COMMENTS ON REGULATIONS AND ADMINISTRATIVE RULINGS—RECENT SUBMISSIONS TO TREASURY DEPT. AND IRS\*

I.R.C. §	DATE	TITLE	COMMITTEE	CONTACT
501(c3) and 4958	01/10/06	Section Comments Concerning Proposed Regulations Under Sections 501(c)(3) and 4958 of the Internal Revenue Code of 1986 (01/06)	Exempt Organizations	Michael A. Clark
n/a	12/29/05	Comments Concerning Partnership Equity for Services	Partnerships & LLCs	Adam M. Cohen
6230 and 6330	12/27/05	Comments on Proposed Regulations Relating to Changes to Collection DueProcess Procedures Under Sections 6230 and 6330	Low Income Taxpayers; Court Procedure and Practice and Practice	Diana Leyden
475	12/07/05	Comments on Proposed Safe Harbor Regulations under Section 475	Financial Transactions	Glenn N. Eichen

\*The technical comments listed in this index 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.

# CLE CALENDAR

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

DATE	PROGRAM	INFORMATION
February 9-10, 2006	<b>How to Handle a Tax Controversy at the IRS and in Court</b> Scottsdale, AZ	ALI-ABA <a href="http://www.ali-aba.org">www.ali-aba.org</a> 800-253-6397
February 15, 2006	<b>Special Teleconference:</b> The ECJ Decision in <i>Marks &amp; Spencer</i> : Impacts and Opportunities"	ABA Tax Section <a href="http://www.abanet.org/tax">www.abanet.org/tax</a> 202-662-8670
February 22, 2006	<b>"Last Wednesday" Teleconference:</b> <i>Cuno</i> Update	ABA Tax Section <a href="http://www.abanet.org/tax">www.abanet.org/tax</a> 202-662-8670
March 16-17, 2006	<b>Fourth Annual International Tax Institute</b> Washington, DC	ABA Tax Section <a href="http://meetings.abanet.org/meeting/tax/gtown06/">http://meetings.abanet.org/meeting/tax/gtown06/</a> 202-662-8670
March 22, 2006	<b>"Tax Link Live" Member Benefit/Ethics Teleconference:</b> Ethical Considerations for a U.S. Practitioner in Planning for a U.S. Multinational Client	ABA Tax Section <a href="http://www.abanet.org/tax">www.abanet.org/tax</a> 202-662-8670
March 27-31, 2006	<b>ABA/IPT Advanced Income Tax, Sales/Use Tax and Property Tax Seminars</b> , Atlanta, GA	ABA Tax Section <a href="http://www.abanet.org/tax">www.abanet.org/tax</a> 202-662-8670
March 30-31, 2006	<b>Sixth Annual Tax Planning Strategies—U.S. and Europe</b> Rome, Italy	ABA Tax Section <a href="http://meetings.abanet.org/meeting/tax/rome06/">http://meetings.abanet.org/meeting/tax/rome06/</a> 202-662-8670
April 19, 2006	<b>"ABA Connection" Member Benefit Teleconference,</b> The Price Is Right: Issues in Valuation	<a href="http://www.abanet.org/CLE/connection.html">www.abanet.org/CLE/connection.html</a> 800-285-2221
April 27-28, 2006	<b>20th Annual National Institute:</b> <b>Employee Benefits in Mergers and Acquisitions</b> New York, NY	ABA-JCEB <a href="http://www.abanet.org/jceb">www.abanet.org/jceb</a> 202-662-8676
May 10-12, 2006	<b>20th Annual National Institute:</b> <b>ERISA Basics</b> Chicago, IL	ABA-JCEB <a href="http://www.abanet.org/jceb">www.abanet.org/jceb</a> 202-662-8676
June 8-9, 2006	<b>Charitable Giving Techniques</b> Boston, MA	ALI-ABA <a href="http://www.ali-aba.org">www.ali-aba.org</a> 800-253-6397
July 19-21, 2006	<b>Estate Planning for the Family Business Owner</b> Chicago, IL	ALI-ABA <a href="http://www.ali-aba.org">www.ali-aba.org</a> 800-253-6397
October 5-6, 2006	<b>Consolidated Tax Return Regulations</b> Washington, D.C.	ALI-ABA <a href="http://www.ali-aba.org">www.ali-aba.org</a> 800-253-6397

## SECTION MEETING CALENDAR

[www.abanet.org/tax/meetings](http://www.abanet.org/tax/meetings)

2006	<b>MAY MEETING</b> , May 4-6, Grand Hyatt, Washington, DC
	<b>JOINT FALL CLE MEETING</b> , October 19-21, Hyatt Regency, Denver, CO
2007	<b>MIDYEAR MEETING</b> , January 18-20, Westin Diplomat, Hollywood, FL
	<b>MAY MEETING</b> , May 10-12, Grand Hyatt, Washington, DC
	<b>JOINT FALL CLE MEETING</b> , September 27-29, Hyatt Regency and Fairmont, Vancouver, BC
2008	<b>MIDYEAR MEETING</b> , January 17-19, Hyatt Regency and Ritz Carlton, Lake Las Vegas, NV
	<b>MAY MEETING</b> , May 8-10, Grand Hyatt, Washington, DC
	<b>JOINT FALL CLE MEETING</b> , October 9-11, Hyatt Regency, Chicago, IL



## NEWS BRIEFS

### 2006 NOLAN FELLOWS

The Tax Section congratulates the recipients of its 2006-2007 Nolan Fellows awards. The following six Nolan Fellows were recently honored at the Section's Midyear Meeting in San Diego.

- **Christopher Condeluci**, Groom Law Group Chartered, Washington, DC
- **Jessica Hough**, Skadden Arps Slate Meagher & Flom LLP, Washington, DC
- **Gregory Lynam**, Baker & McKenzie LLP, San Diego, CA
- **Veronica Rouse**, Internal Revenue Service, Washington, DC

- **Bahar Schippel**, Snell & Wilmer LLP, Phoenix, AZ
- **David Strong**, Holme Roberts & Owen LLP, Denver, CO

Named for the late Jack Nolan, a dedicated and respected Tax Section member, the distinction is awarded to young lawyers who are actively involved in the Section and have shown leadership qualities. Each one-year fellowship includes waived Meeting registration fees and assistance with travel to some Section meetings. Congratulations to the new Fellows!

### TAX TIPS ON DISASTER RELIEF AND CHARITABLE GIVING

[WWW.TaxTips4U.ORG](http://WWW.TaxTips4U.ORG), the Tax Section's innovative consumer website, provides information for taxpayers, charitable and nonprofit organizations, small businesses, and the self-employed. The website includes the latest information concerning federal tax relief for natural disaster victims, including those affected by Hurricanes Katrina, Rita and Wilma, and important tips on 2005 charitable deductions and the special *Hurricane Effect* rules.

## TAX BITES PUZZLER

Compiled by Gail Levin Richmond, Fort Lauderdale, FL

### FAMOUS TAXPAYERS CROSSWORD

This edition of Tax Bites offers a new contest. In keeping with past policy, the winning entrant(s) will be offered a stint as a guest columnist. We have provided a numbered grid for your use in solving this puzzle, but—as an extra challenge—we have not indicated which spaces are blank. Fill in the answers to the clues shown below. The answer may be the taxpayer's first name, last name, or nickname.

#### Across

- Were his out of pocket expenses for charity "to" or "for the use of"?
- "Father" of Robby, Chip, and Ernie
- The IRS meets the will of Perry's creator
- David and Ricky's dad
- Nixon-era figure; he held his hand close to a flame
- A hockey case plaintiff; his one season in the NHL was with the Boston Bruins
- The IRS challenged the tax exemption of this family's cemetery corporation because it was for family members only

#### Down

- Even the governor of Arkansas can have tax problems
- Was this actor's home in New York or California in 1937?
- A younger family member dated Elizabeth Taylor
- Smile, you're on candid camera

1	2	3	4	5	6	7	8	9	10	11
12	13	14	15	16	17	18	19	20	21	22
23	24	25	26	27	28	29	30	31	32	33
34	35	36	37	38	39	40	41	42	43	44
45	46	47	48	49	50	51	52	53	54	55
56	57	58	59	60	61	62	63	64	65	66
67	68	69	70	71	72	73	74	75	76	77
78	79	80	81	82	83	84	85	86	87	88
89	90	91	92	93	94	95	96	97	98	99
100	101	102	103	104	105	106	107	108	109	110
111	112	113	114	115	116	117	118	119	120	121

- He tried to deduct confirmation expenses that exceeded his potential compensation
- He was paid for a Red Beret
- His PHC couldn't coach basketball

**Extra Credit:** Provide the correct citations for the tax case involving each taxpayer.



## **ABA SECTION OF TAXATION**

[www.abanet.org/tax/](http://www.abanet.org/tax/)

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