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Section of Taxation
NEWSQUARTERLY

POINT & COUNTERPOINT

Tax-Free Overtime Pay

With the highest number of French voters going to the polls in 40 years (84%), Conservative Nicolas Sarkozy defeated Socialist Ségolène Royal in France's presidential election in May. Sarkozy's platform for France was one of change, attempting to spur economic growth that was 2.1% last year, an increase that ranked tenth of the twelve European countries that utilize the euro.

To stimulate the economy, the world's sixth largest and second in Europe to Germany, Sarkozy proposes the elimination of a 2000 French law that mandated a 35 hour workweek, a law designed to help create jobs for more people and give current workers more personal time. Sarkozy claims that the law did not create additional jobs but instead created expectations of current workers to do more in less time. To encourage French workers to work more and to improve the slumping French economy, Sarkozy proposes to make overtime pay tax free.

In this Point & Counterpoint, Professors Richard Schmalbeck and Michael McIntyre debate the merits of taxing labor income. Professor Schmalbeck offers his view that Sarkozy's plan offers a genuine choice between work and leisure. Professor McIntyre argues that his plan raises significant policy issues of tax fairness.

The *NewsQuarterly* encourages readers to submit responses or comments to these essays, which may be published in a subsequent issue. *—Christopher M. Pietruszkiewicz, LSU Law Center, Baton Rouge, LA*

POINT

The Sarkozy Proposal is Worth a Try

By Richard L. Schmalbeck*

There is much to be said for this plan on grounds of efficiency. Oversimplifying more than a bit, one can say that taxes tend to be less efficient if they distort people's choices. So if people buy a second-choice good because of a stiff tax on their first choice, or pass up an opportunity to make some extra cash working an occasional Saturday because of an income tax rate that's too high, there is a loss in consumer welfare.

Economists generally think that taxes on income from employment are acceptably efficient, because they do not seem much to prevent people from engaging in employment. This is in part, however, because of rigidity in labor markets. We

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2008 MIDYEAR MEETING
Lake Las Vegas, NV • January 17-19
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Manuscripts and letters should be mailed to: Assistant Staff Director, Publications, ABA Section of Taxation, 740 15th Street, NW, Washington, DC 20005.

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2008 MIDYEAR MEETING

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Please join the Section in Lake Las Vegas, NV for two full days of CLE and the opportunity to learn from and network with the tax profession's leading voices from private practice, government and academia on the latest policy initiatives, practice issues, regulations and legislative forecasts.

REGISTER ONLINE—IT'S QUICK, EASY, AND SECURE

Register online for the upcoming Section of Taxation Midyear Meeting at:
http://www.abanet.org/tax/meetings/midyear08/
Register by December 13th to qualify for our "early bird" discount!

HOTEL RESERVATIONS

The Loews Lake Las Vegas Resort (headquarters hotel) and The Ritz-Carlton, Lake Las Vegas will be hosting the 2008 Midyear Meeting. Registration will be available at both hotels. To make reservations at the Loews Lake Las Vegas Resort, call 702-567-6000, and ask to be routed to in-house reservations. Refer to group code ABA113 or "American Bar Association." To make reservations at the Ritz-Carlton, Lake Las Vegas, call 800-241-3333, and refer to the American Bar Association Section of Taxation. The deadline for room reservations is December 20, 2007.

PROGRAM HIGHLIGHTS

Please visit the website – http://www.abanet.org/tax/meetings/midyear08/ – for a complete schedule of CLE programs and networking opportunities.

Over 100 CLE programs and at least 3 hours of ETHICS credit will be offered during the 2008 Midyear Meeting. Programs will address a range of hot topics in every specialized area of tax, including over a dozen programs for Young Lawyers, and special Saturday afternoon CLE covering topics with more general appeal, including:

- Current Developments in Individual, Corporate, Partnership and Estate & Gift Taxation
- Everything You Need to Know About the New PPA'06 Funding Requirements But Haven't Had Time to Learn
- New Regulations on Capitalizing Costs of Acquiring and Improving Tangible Assets
- Status of the Streamlined Sales Tax Project
- Your Client's First Foreign Subsidiary: The Tax Basics That You Both Need To Know

EVERYTHING YOU NEED TO KNOW ABOUT THE 2008 MIDYEAR MEETING CAN BE FOUND AT: http://www.abanet.org/tax/meetings/midyear08/

Stanley L. Blend*

I am pleased to be writing my first column as Chair of the Section of Taxation, and to follow on the terrific leadership of our immediate past chair, Susan Serota.

As you may know, the Section's activities over the last year were prolific. Just in our Government Relations area, we were involved in more than 50 comment projects, spanning myriad substantive issues in tax law. We also visited with congressional and federal agency staffs, and met informally with others on proposed regulations, rules and issues facing the practice of tax. Our Committees continue to be as active as ever; please see the Government Submissions Boxscore page in this issue of the *NewsQuarterly* to review comments that have been submitted over the past few months. The Section continues to participate in programming dealing with the patenting of tax strategies, and continues to lead educational efforts on Capitol Hill. Patenting Tax Strategies Task Force co-chairs Dennis Drapkin and Ellen Aprill have been quite active in communicating with our members, other lawyer groups and organizations in the accounting field, to keep everyone apprised of developments in this area. In addition, we plan to continue providing instruction to patent examiners in the manner in which to research whether a particular tax strategy is unique and whether there is prior art. In early September, the House of Representatives passed legislation that would prohibit the patenting of tax strategies. The Senate is expected to work on its own patent reform bill in this session of Congress.

Our Joint Fall CLE Meeting with the Real Property, Trust and Estate Section (formerly Real Property, Probate and Trust Law) was a big success. Many members chose to attend the Meeting to take advantage of the beautiful destination—Vancouver, British Columbia. The city offers wonderful scenery and outdoor activities, as well as terrific restaurants and nightlife. The CLE programming was outstanding, and we continue to enjoy great success from our collegial relationship with RPTE.

Our next meeting is a great destination as well—we'll be at the Loews Hotel and The Ritz-Carlton in Lake Las Vegas, Nevada, January 17-19, 2008. We anticipate a large attendance for this meeting as well, so be sure to register early and make your hotel reservations.

In addition to the high-quality CLE programming that is offered at the Section's three annual meetings, we also sponsor a variety of CLE programs that can be accessed from anywhere there is a phone. I urge you to sign up for one of the Section's monthly "Last Wednesday" teleconferences. These 90-minute programs are held on the last Wednesday of each month. We welcome your feedback on topics of interest to you, and those that may help you in your practice. Our Professional Services Committee, chaired by Charles Lavelle, and overseen by our Vice Chair–Professional Services, Sam Braunstein, steers the planning for the "Last Wednesday" programs and will take your ideas into account.

We also have successful CLE partnerships with a number of outside organizations, among them the IRS, ALI-ABA, IBA, IPT, Georgetown, Philadelphia Tax Conference, and several state and local bars. This CLE programming provides specialized conferences and meetings throughout the year. Please see the CLE

Our Joint Fall CLE Meeting with the Real Property, Trust and Estate Section (formerly Real Property, Probate and Trust Law) was a big success. Many members chose to attend the Meeting to take advantage of the beautiful destination—Vancouver, British Columbia. The CLE programming was outstanding, and we continue to enjoy great success from our collegial relationship with RPTE.

* Oppenheimer, Blend, Harrison & Tate, Inc., San Antonio, TX.

Calendar in this issue for upcoming programs that might appeal to you. Due to the success of our annual U.S.-European Tax Planning Strategies Conference, now going into its eighth year, we are expanding our CLE offerings in the international tax arena and plan to undertake a two-day conference focusing on U.S.-Latin America tax planning strategies, which is tentatively scheduled for June 2008. Join us for one or more of our CLE programs, and you'll see why they are consistently considered some of the best in the market.

The Tax Section Council recently approved the formation of a new Committee on Publications. The Committee's mission is to focus and develop the Section's publishing program to serve our members, the tax profession, and the public. In coming months, the Committee will be looking at updating or expanding publications such as *The Tax Lawyer* and the *NewsQuarterly*, and possibly developing new titles. This issue of the *NewsQuarterly* is an example of some of the cosmetic changes we are making to our publications to incorporate the Section's new logo and design. If you are interested in writing for one of the Tax Section's periodicals, or proposing a new publication, please contact Lou Mezzullo, Vice Chair – Publications.

As Chair, I have the great honor of serving you, the members of the ABA Section of Taxation, during the next year. I hope that you will work, along with me, to make the Section as successful as we can be.

Finally, the Section's Officers, Incoming Officers, Council Directors, and Incoming Council Directors held a retreat this past July to discuss Section activities, procedures and policies. Our discussions focused on how the Section can best meet its goals, and how we can better serve our members. Among other items, we reviewed our government submissions process, the value of our visits to Capitol Hill, the format of our meetings, and our CLE and member outreach. If you have thoughts about any of these issues or others, please let us know. You may reach Tax Section staff at 202.662.8670 or tax@abanet.org. We welcome your ideas and feedback.

As Chair, I have the great honor of serving you, the members of the ABA Section of Taxation, during the next year. I hope that you will work, along with me, to make the Section as successful as we can be. Thank you for the opportunity to serve. ■

NEWS BRIEFS

JANET SPRAGENS PRO BONO AWARD NOMINATIONS SOUGHT

Each year the Tax Section presents its Janet Spragens Pro Bono Award to a member or members of a firm who devote their time and energies to pro bono representation, particularly representation of low-income taxpayers. The award may be based upon any of the following criteria:

- Handling a significant number of tax controversies for low-income taxpayers on a pro bono basis over an extended period of time, or intensive involvement over a limited time with significant impact
- Voluntarily forming, operating or participating in organizations, such as low-income taxpayer clinics (LITCs) devoted to representation of low-income taxpayers, particularly if such participation is over an extended period
- Formation, supervision and participation in programs to assist tax controversies, including "attorney of the day" programs for the Tax Court
- Mentoring law students and other individuals who work for LITCs
- Preparation of resource materials for LITCs and other low-income programs
- Providing pro bono legal assistance to tax-exempt organizations, especially those formed to help low-income taxpayers

PLEASE SEND YOUR NOMINATIONS ALONG WITH SUPPORTING MATERIALS BY MAIL OR E-MAIL TO:

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The deadline for nominations is December 1, 2007.

News Briefs continued on page 23

Sheldon S. Cohen

By Jasper L. Cummings, Jr. and Alan J.J. Swirski*

Sheldon Cohen is a director of Farr, Miller & Washington, PC, Investment Counsel, in Washington, DC. He is a certified public accountant and an attorney and served as Commissioner of the Internal Revenue Service in 1965-1969 and as Chief Counsel in 1964-1965.

Q What is your opinion of the state of voluntary compliance with the tax laws today compared with when you were Commissioner?

A Well, life is much more complex today. Although the Code is more complex and business is more complex, the Service is smaller in relation to the population and compliance has decreased. There's an old Yiddish expression which says—"he thinks he is an honest man who is not given the opportunity to steal." We try to design systems in the tax law and tax return preparation to keep honest people from becoming thieves. Thieves are thieves anyway; so we try to design a system in which people will not be tempted.

Now transplant yourself back to the early '60s. The Revenue Service was the first major system in the world to utilize a computer, and luckily it worked. People thought we could do more than we could do, and, by the time we finished, we could do most of the things we said we could do. But at the beginning when we were checking 1099 forms, we were checking one or two letters of the alphabet, but one or two letters in the alphabet was better than none. By the time we were finished, we were doing them all. Since people expected that their returns were being checked, they behaved that way.

I recently told the congressional committees that they didn't get into this compliance hole in one year and they are not going to get out of it in one year. There is no magic elixir. We need increased enforcement, and collection, audit, and surveillance activity of various kinds. We also need increased audits to prove to people that there is a penalty if you do not comply. Audits function as a deterrent, just like a police car sitting on the shoulder of a highway slows down traffic. Knowing that a friend, business associate, or somebody you know is being looked at is a deterrent, because it makes you think "well, maybe I ought to be more punctilious about complying." We have lost all that.

Q When you were Commissioner, did you view the intensity of audits as important as the number audited?

A Both, you need broad and you need wide. You cannot do slapdash audits of major concerns because they will bury the problem where you will not see it. On the other hand, you cannot go deeply into everybody, so you have to have some system. That was what drove us to TCMP (Taxpayer Compliance Measurement Program), the first scientific audit program to try to ferret out what is really happening out there. Agents were using the criteria that they traditionally used picking returns for audit and we would run 50% no change. When we adopted TCMP, I had to go to the Appropriations Committee and tell them our compliance would not be affected but that our audit results might be because we were going to do a cross section of returns in order to establish a baseline. We discovered that within three or four years of TCMP audits, we were down to 18% no change audits. That is a dramatic result (the last time I looked they were up around 26 to 30%).

Q You were a drafter involved with both the 1954 Code and the original regulations issued thereon. Tell us of your role in the drafting of the Code and how that process went.

A I graduated law school at the end of the summer school session (1952) so I was off kilter. Even though I was offered a scholarship, a teaching fellowship, and a job at a major law firm, I would have had to wait six months to start. Instead of waiting, I just decided to go to work for the IRS because that was where all the action was in those days. The best tax lawyers in the '50s and '60s came out of the IRS. The assistant chief counsel who interviewed me hired me on the spot and assigned me to L&R because he said I would do the best there.

The very first project I got in 1952 was to amend a section of the law that nobody had ever heard of. I took a draft to Ed Kraft (the House legislative counsel) who tore it apart; four hours later we had a new draft. He looked at me and he said "Sheldon you draft the committee report." That was the first time I understood somebody drafted the committee report. You have to understand that law schools in those days were less sophisticated than law schools today. I knew there were committee reports, but I figured the committee staff drafted them. Luckily, I had taken good notes and I went off to draft it.

The Republicans announced a major tax program when they won the election in the fall of '52. One of the major projects

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that the Eisenhower administration had, George Humphrey being the Secretary of Treasury, was accelerated depreciation. Of all the people working at the Treasury and at the IRS at this time, I was the only CPA, so I was the only one who understood a good deal of the accounting material. There was one CPA who was later recruited by the Treasury as a short termer from some of the major accounting areas who helped me later on. So I drafted accelerated depreciation in the House and later in the Senate. The business community was unhappy with some of the rules I wrote in the House and they tried an end run around me by asking for something called sum of the year's digits depreciation in the Senate. They thought it could overlook salvage value.

The lobbyists were less effective then and did not really understand the process nearly as well as they do today. So when I drafted the sum of the year's digits method in the Senate, I just automatically put in salvage value. And I did it because it was the right thing to do and because all the theory books told me to do it, not because I was trying to do anybody in. So we got the right answer although it was not the answer the lobbyists were looking for.

In fact I remember the boss came to me at 3:00 one afternoon and said "Sheldon, the Senate Committee wants to look at sum of the year's digit method depreciation." I said "What's that?" He said, "I don't know. That's all we have but you need a draft by 10:00 tomorrow morning." By midnight, I had read every accounting text in the library. I was the only one in the building, everybody else went home. I found a footnote in the *Accountant's Handbook* describing it. I still have the *Accountant's Handbook* at home. It described the method in example form, there was no verbalization, I had to verbalize it. So that was my night. My wife did not see much of me those few months.

Everything was less sophisticated. There were just a few of us, mostly zero to six years out of school, who drafted the entire '54 Code and the entire set of regulations. Many of the group were at L&R, and a few in the Treasury, with a few supervisors.

They recruited a few, mostly fellows, there was only one woman in the whole group, to help us with the regs and we worked in teams. There would be a three or four person group, for example, on the depreciation regs, which were the major regs. There was me, an economist from Treasury, a lawyer from the Joint Committee staff, and so on. We wrote reports to the Assistant Secretary and Chief of Staff of the Joint Committee. It was a joint project. The Joint Committee staff and the House Ways and Means and Senate staffs all worked as a group, which eliminated a lot of superficial reviews and turf wars.

I just decided to go to work for the IRS because that was where all the action was in those days. The best tax lawyers in the '50s and '60s came out of the IRS. The assistant chief counsel who interviewed me hired me on the spot and assigned me to L&R.

Q Who oversaw that group?

A The review committee consisted of Colin F. Stam, the Chief of Staff of the Joint Tax Committee, Ken Gemmill and Dan Throop Smith, who were the Treasury people, one lawyer and one economist. They would usually meet in Dan's office or Mr. Stam's. Mr. Stam was an old man by then and when we made fun of him when he would look like he had fallen asleep, he was actually wide awake. Then he would snap out of it and look right at you and ask you the questions you did not know the answer to. It was pretty clear that he was listening and understood everything you said to him. I was a 25 year old kid and he was a 65 year old man, so he seemed like 140 years old to me.

The supervisory group was very good and they were very cooperative. It was almost seamless. This was the first time the Republicans had had the Congress, both houses, for many, many years. They only held it for the two years but they struck and enacted major changes pretty effectively.

Q About lobbying, you mentioned it was less effective then than it is today. How did it occur back then?

A I was in executive sessions where the most important things in those days happened. The lobbyists were out in the hallway or in the lobby. And you would see members go out and you would see a messenger come in and hand them notes. It was a lot cleaner in the sense that there were less hands involved in it. Therefore the chances for deterioration of the system because of some particular person's problem or business's problem were much less.

The Eisenhower crowd was very effective. Dan Smith had been a professor at Harvard Business School. Ken Gemmill was a well known tax

> The supervisory group was very good and they were very cooperative. It was almost seamless. This was the first time the Republicans had had the Congress, both houses, for many, many years. They only held it for the two years but they struck and enacted major changes pretty effectively.

lawyer. They were co-heads of the study at the Treasury. Interestingly enough, just before the Code was updated, a small group of three people actually rewrote the entire income tax regulations. Imagine rewriting the entire income tax regulations in less than ten months. I was the youngest one in the group and was given the dirty jobs like the administrative provisions and the indexing.

When we did the '54 Code, my roommate, Bob Winokur, did the rearranging of the substantive provisions. Before 1954 every tax had its own administrative provisions and they were all different. The assessment rules were different. All sorts of rules were different. One of the projects was to make sure they were the same, that we got them as close together as we could. I did the rearrangement of all the administrative provisions. Everybody said I had the dirty job because I had the non-substantive stuff. Of course, it turned out that my project lasted longer than his. If you draft a substantive provision, you can bet your life they are going to change it. If you draft an administrative provision, you can bet your life they are not going to change it.

Q So the regulations issued under the 1954 Code were largely a rearrangement of regulations that had just been written under the 1939 Code?

A Yes. The last set of regs under the old Code was reg 118 and was updated and issued sometime in 1953. Then the 1954 Code was adopted August 16, 1954. I was told to get the regs on depreciation out by October and I had a notice of rulemaking dated early in October.

When they were actually adopted in '55 they were largely a cleaned up version of the 1953 regulations, put all in the same style. We set up the subsection numbering system that still exists. I still remember a lot of the administrative stuff not because I am very smart but because I am the only person who ever looked at it. Nobody ever looks at that until you get a case and you say "Okay, how do you assess a tax? How does it really work?" So it has helped me in a few cases every once in a while. Bob Winokur did all the income tax rearrangement and I did all the administrative provisions.

The heroes are the supervisors, Eddie Kahn, Herb Allen, I could name a half a dozen supervisors who had been around—but most of us were green as grass.

Q You served under President Johnson. What was the level of his interest and involvement in tax matters?

A Immense. He would call me all the time. The very first year of his presidency, President Kennedy came to the IRS building when they had their annual meeting of field supervisors, the district directors, and the regional commissioners. I was chief counsel when Johnson took over and I asked him if he would like to come to the building. He said "no, why don't you come here." So Commissioner Caplin and I loaded our entire top staff on buses and we went to the White House for coffee and cake. The president gave everybody a pep talk, and the next year we did it again, and the third year I arranged for the vice president to come to the IRS building and give them a pep talk and I got a call from the president.

The president called me and said "don't you love me anymore?" I said, "What did I do now?" He knew what we were doing. And I said "I thought we'd imposed enough on your time." He said "No, I like to do it." I said, "Fine, I'll bring them over," and we loaded everybody on the bus and went over there.

He enjoyed talking with line people. Early in his career he had been part of the National Youth Administration under President Roosevelt and he knew what it was like to be a subordinate and not see the boss. He gave them a wonderful speech about doing a good job, that we have a fair tax system, and that we have to make it better. He exhorted them to jack up the administration and their work level and so on, and it was terrific. My wife took all of their wives over for tea with Mrs. Johnson. It was very good for morale to know that the boss is interested in your program. We did it every year for the whole five years.

Q Now, you have advocated some reform of the taxation, or nontaxation, of exempt organizations. What changes do you see as needed?

A A number of years ago Jack Nolan and I went to a conference at Ditchley. Ditchley is a conference center at Oxford, England where they invite

I always thought that running the IRS was like running a large spaghetti factory. The problem is, you have got to taste the spaghetti every once in a while. You need to have enough technical competence to be able to taste it to see whether the product is good. If you get a non-technician before a congressional committee and they ask him the most simple elementary technical question and he flounders, it does not look good.

15-20 Americans and 15-20 Brits to talk about a problem that is common to both systems but treated differently in both systems. When Jack and I came back we made a proposal regarding the way charitable organizations are handled. We testified before the Ways and Means Committee and wrote about it.

The British have a charity commission and the charity commission is designed to encourage charities and to write the rules and regulations about charities. The rules are written by the charity commission but are enforced by the tax authorities as if they were revenue law. We thought that would be good for the United States because the IRS has this two headed role—the commissioner in charge of that function is both an encourager of charity and an enforcer of the rules of charity and that has always been a problem. It has been administered pretty well recently, but you still have this idea that we need more and better rules and we need stricter enforcement. Enforcement has been pretty meager. If you look at a few thousand of the millions of exempt organizations, you are only looking at a small fraction. And there are so many strange things going on, we see them in our newspapers all the time.

Jack and I thought that it would be a good idea to separate the encouragement from the enforcement roles. We never got much traction on the idea. It comes up every once in a while, John Gardner was flirting with it when he set up some of his Independent Sector ideas. He wanted that to be encouraging, but that is a private group. There are a variety of ways to do it, not just one way. I'm not going to say that our idea has got to rule. It is just I think that there is a festering problem here.

It is not going to go away, either, and nobody wants to face it. It is the devil I know for the devil I don't know. The charities stay with the status quo. They know the system, they have dealt with the system, they feel they can work with the system, and they would rather keep the present system. The IRS does not look for any additional work because anytime you change something it takes more work to put it in to effect. So, we stay where we are and then we complain about the system.

Q What do you think of the shift of Commissioners from CPA or tax lawyer model to business model?

A We had that for a long time. Eisenhower appointed several non-tax people. T. Coleman Andrews and Russell Harrington were both non-tax CPAs. I used to write speeches for Mr. Andrews and the staff would give me hell because he would say something that was completely wrong and I would show them the draft. The draft was right. He freelanced. He did not know enough tax to know when he was going off the reservation. He had a good sense of business as did Mr. Harrington, but they were not tax people.

I always thought that running the IRS was like running a large spaghetti factory. The problem is, you have got to taste the spaghetti every once in a while. You need to have enough technical competence to be able to taste it to see whether the product is good. If you get a non-technician before a congressional committee and they ask him the most simple elementary technical question and he flounders, it does not look good. No one knows everything in the darn Code. And, as the Code grows, it gets harder and harder. However, it does help to have a working knowledge of the way the system works. I know, for example, the way an appeal system works, I don't have to go out and get briefed on that.

My own view is that it is basically a management job, with about 100 to 105 thousand people, you know you have got to move people around. I left the revenue service as a grade 12 in 1956 and came back as chief counsel six and a half years later. Although I was young, only six or seven years out of the IRS, I knew enough people in the Service that I could rely on, they were really first rate technicians. The first thing I did was to interview each of them separately and ask them who are the good people, who are the people I ought to recruit to the leadership positions here. And interestingly enough, at least two-thirds of them said Lester

Uretz, who ended up being deputy chief counsel and then later chief counsel. I had never met the man before. So the most important thing is still people. The operation of the Revenue Service, or any government agency, is people. It is recruiting good people, keeping good people, motivating good people, and finding the right mix of people, the right kinds of talent. You can sit back and float at that point.

Q When you were Chief Counsel and then Commissioner, what privacy norms or rules covered the Service's retention of information?

A There was a 6103, I mean 6103 was not nearly as broad as it ended up being in '76 and beyond. But there were confidentiality rules. I do not want my tax return spread all over the Washington Post, even a list of the charities that I give to. We each reveal private information to the Revenue Service because it is required. If it is made public, it can be used for blackmail, it can be used for kidnapping, there are a whole variety of problems—you can't think of them all.

We had situations where gamblers were reporting honest tax returns while violating every gambling law in the state. If their returns were revealed, they would stop reporting. If you prosecute one, then it is over. So you have to make your choice. We had a tax system that included lots of illegal income reported. Most people did not know that, but we knew it. If you reveal it then there will be pressure to reveal it and then you will lose the revenue and become a police agency. The purpose of this system is not law enforcement. The purpose of this system is financing the government.

Q Why do you oppose private collectors for tax debts?

A Because if there is anything that is governmental it is defense and taxation. You cannot turn over to the private collector the discretion as to whether a penalty applies or does not apply. Every time there is a question they will throw the question back to you. All you have done is double the administrative work for no purpose. I asked Mr. Rossotti and his staff when they first proposed the idea—if they could use the same money on collections officers instead of outsourcing it, would they ultimately collect more or the same. And the answer is we would collect more. We would be more efficient, we would have less questions, we would not have to review back and forth. Then the answer is go get more money. This last congress seemed to be more ready to appropriate money to pay to a stranger than to pay their own employees. The Revenue Service has been an efficient organization, one of the best in the country, it is one of the best in the world. Then, entrust them and let them go do their job—and give them the funds to do it right.

Q You presided over substantial modernization of IRS systems. Why does it seem to be so hard for the IRS to move its systems into the next generation?

A I was lucky. We had a terrific career staff. We recruited most of our staff out of the military or defense agencies. Interestingly enough, I remember one of the computer people was a supply person. He had been the inventory supply person for the Navy. Keeping track of taxpayers is like keeping track of parts for Navy ships. And the only people who ran large computers were the military at that time. We were the first non-military governmental function to have them. So we recruited the good people, we used a good system, we used the best equipment, no cheap stuff. We did not cut any corners.

I remember the first year we put in the computers, the staff recommended we go cold turkey, that is computers, no paper. And I said, no, no, no. I am not going to be the Commissioner on whose watch the system fails. So we did it both ways that first year and the computers worked fine. So the next year we switched off. But we used the very best IBM equipment. IBM was proud and wanted the system to work, so they put their best people on it. When we had a problem, everybody in the organization showed up to fix it. And there was nobody more surprised, or pleased, to see it work than me.

For example, when I was chief counsel, I did the first computer search for a reg. They sent me a reg in which the phrase "disposed of" was used in a rather strange way so I wanted to see every time it appeared in the Code. At that point, we did not have a copy of the Code on a computer so we had to get it from one of the universities. The computer took 20 minutes or a half an hour and found 120 occurrences. The two lawyers in L&R who were assigned the project took two days and found 70 or 80 occurrences. That was the very first time that we ever used the computer for research.

The computer made us much more efficient and it was remarkable what it did. We were able to pick up frauds, we were able to pick up a variety of things that the human being would have missed, although the human eye is still pretty good. I remember once a computer technician catching a person in Detroit who had filed several fraudulent returns. First, she noticed a perfect return, that is the return had every voucher attached to it. Now that is rare. But the next day she saw another one just like it. It was a little suspicious to see another perfect return. She asked her supervisor if she could go back and look at the one the day before. They brought it back and it was identical down to the receipts, that is the receipts to the charities were exactly the same receipts, attached to both returns. And we caught a fraud within a few days. ■

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probably would see more people declining some labor opportunities if they could, choosing to work 30 hours per week, or 25, or whatever, if that choice were freely available to them. But most jobs—at least the good, well-paid jobs that people want for a career—are packaged up in full-time bundles, take it or leave it.

But overtime is different. In many cases, it is optional. In particular, it sounds as if the Sarkozy proposal contemplates mostly voluntary overtime. (If it weren't voluntary, there would be no need to encourage it through tax incentives.) That means that the affected worker really may be making a close choice at the margin. The choice is not the easy one: do I want a job, or do I want my family to starve? It's more like: do I want to take a bike ride with my family this Saturday, or would I rather work that day so I can buy them better bikes? Close choices are easily distorted by taxes, so if we want to avoid distorting the overtime choice, what better way than to get the tax out of the way?

For reasons related to these fundamentals of welfare economics, optimal tax analysis has long maintained that the most efficient tax structure is not one in which graduated marginal rates march upward as income does, even though that is the rate structure that most advanced economies have embraced. A more efficient structure, even if a society wants to have a tax system that is progressive overall, is to have a large exemption from tax, followed by rates that either ascend rather gently, or don't ascend at all.

It has been convincingly argued, however, that it is very difficult to achieve enough progressivity in a tax system if the system refuses to use significantly graduated rates. But the Sarkozy proposal is not one that would lower marginal rates in the upper and middle income brackets generally. Rather, it would be targeted exclusively at those workers making those last marginal choices about the shape of their work week.

There may be some important practical problems in designing the overtime exclusion so that it is available only in genuine overtime situations. And to achieve workable rules, there may be inequities, as there always are when administrative concerns dictate outcomes. (For example, the system would be easier to design if its rules favor someone who works 45 hours per week for a single employer over one who works 35 for one employer and 10 for another.) These inequities might well doom any practical proposal.

There is, of course, a major equity concern about any tax system that exempts what may be significant slices of the incomes of some, but not other, taxpayers. It violates first principles of equity to create a system in which one taxpayer with a $45,000 income from "regular" work pays more tax than another who has an income of $50,000, composed of $40,000 from regular work and $10,000 from tax-free overtime. But those equity concerns will be muted by the realizations that:

- There are natural limits to the proportion of one's income that can come from overtime;
- Taxpayers who earn a substantial amount through overtime do take a non-trivial lifestyle hit; they will not necessarily be envied by their relatively overtaxed but underworked fellow citizens (especially, one imagines, in France);
- This is, after all, income from labor, and, for the most part, from the middle and lower parts of the distribution. Executives, athletes, actors, professionals, and capitalists would be unlikely to benefit from any reasonably well-designed program along these lines; because of that, it's even possible that tax-free overtime would improve progressivity, albeit in an admittedly erratic way;
- If overtime opportunities are or become widely available, taxpayers will decide for themselves how much overtime they wish to work, according to their work/leisure preferences, so everyone will live happily ever after.

Or maybe not, but it seems worth a try.

COUNTERPOINT

Creating Tax Unfairness

By Michael J. McIntyre*

President Nicolas Sarkozy's promise to change the famously relaxed French way of life by inducing French workers, through a tax exemption for overtime pay, to spend more time in paid employment presents two public-policy issues. The first, of great concern to France, is whether a tax subsidy for overtime pay will benefit the French economy. The second, of major concern to me here, is whether such an exemption can be squared with legitimate concerns for tax fairness.

In evaluating a tax subsidy, the first step is to determine its expected cost in forgone tax revenue. I have no good idea of that cost and suspect no one does. The amount would include the tax currently raised from taxing overtime pay, plus the amount that would be lost from workers and employers restructuring their work arrangements to make regular pay appear to be overtime pay. There also would be some lost tax revenue from employees electing to work more overtime, thereby displacing in some cases other workers. I think that latter cost is likely to be low because I'm very skeptical about the effectiveness of a tax subsidy for overtime pay in inducing French men and women to work longer hours.

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There is substantial evidence that full-time workers generally do not work longer hours when offered higher pay (or its equivalent, tax-free pay). Economists speculate that this inelasticity of hours worked is due chiefly to the inability of most full-time workers to control their work week. That is, workers generally must decide whether or not to work, and, if they work, they typically are required to work the standard amount, no more or less. Some economists suggest, nevertheless, that if workers were offered a practical option of working overtime, they might do it if they were given a sufficient economic incentive. The Sarkozy plan would make overtime more lucrative for workers. It would do nothing, however, to remove the structural obstacles to working longer hours. As long as those alleged structural obstacles remain, I see no basis for a belief that the plan would be effective in changing the behavior of French workers.

Computing the value of the benefits of the Sarkozy plan is even more difficult. Frankly, I do not understand why Sarkozy wants to induce French workers to spend more time at their job. The French unemployment rate is fairly high, typically in the range of ten percent overall and double that rate for young workers. Longer hours for some workers would tend to reduce the jobs available for other workers, particularly younger workers. In addition, increasing the labor supply would have a tendency to depress wages. I'm not sure why these results are desirable at all, never mind being results that the government would want to spend good money to achieve.

The alternative to a government subsidy for overtime would be a decentralized program whereby employers who were facing a particular labor shortage would pay workers higher wages for overtime. The classic formula is time and a half for normal overtime and double pay for holidays. The advantage of this market approach is that it is highly flexible, it links the subsidy to specific needs of employers, and it costs the government nothing. The disadvantage is that no one would believe a candidate for president of the French Republic who contended that the plan would rejuvenate the French economy. Tax incentives do not have economic magic, but they do seem to have some political magic.

As noted above, I am mainly interested in discussing the fairness of the Sarkozy plan—actually, its serious unfairness. That unfairness is nicely summarized in the mantra of the Carter Commission, coined over 40 years ago, which proclaimed that "a dollar is a dollar is a dollar." (See REPORT OF THE ROYAL COMMISSION ON TAXATION, Canada, 1966.) The obvious point is that a euro earned from working overtime has the same spending power and the same savings power as a euro earned from working normal hours. As a result, overtime pay should not be treated favorably in a tax system that seeks to distribute tax burdens with respect to a taxpayer's market consumption and savings.

The classical argument, once endorsed by France, for giving a preference for income derived from wages over other forms of income is that workers must sacrifice their leisure in order to obtain their income, whereas investors need not get up from their chairs to collect their dividends, interest, and royalties. France abandoned that position years ago, however, when it repealed its differential tax rate for earned income. I never liked the theory because the investor also can claim to have given something up—the right to current consumption. Indeed, anyone engaged in a market exchange gives up something. In a traditional income tax, a taxpayer must have basis in the thing given up to get a tax benefit, and no one has a basis in their leisure or in their right to consumption.

Whatever the merits of that "giving up" argument (for leisure or for consumption opportunities), it is not a good argument for not taxing workers named Jacques, or, in Mr. Sarkozy's case, for not taxing individuals on income generated by overtime work. The obvious example of inequity is the person making $500 per hour who works overtime and the person making $5 per hour working overtime. They both give up the same leisure, but the tax benefit to one is huge and to the other is trivial.

An alternative way of looking at the equity problem is to speculate on who would take up the offer of a tax subsidy for overtime pay. Again, I'll give two extremes. Nicole has three children and four dogs, and her household falls apart if she works more than 35 hours a week. It may even be in serious trouble with her working more than 20 hours a week, but she needs the money. Louis has so much time on his hands that he spends 60 hours a week engaging in angry discussions of the Iraq war on the Internet. Nicole will not respond to the subsidy offer, whereas Louis would grab it in his teeth and never let go. Nicole is already giving up far more, in terms of the value of her leisure, than Louis. Why, exactly, should Louis (rather than Nicole) get the tax benefit, if the value of leisure forgone is the new test of taxable capacity?

Of course, if we are prepared to assume that everyone makes the same amount of money aside from overtime pay and everyone has the same preference for leisure, then we can see the beginnings of the equity argument for giving a tax benefit for the assumed value of leisure. Only in economics class, however, is credit given for making counterfactual assumptions. In the world we actually live in, the primary tax problem arises from the huge disparities in income between the rich and middle classes. It is not helpful in addressing that problem to simply assume that those disparities do not exist.

I do acknowledge that Mr. Sarkozy could reduce the unfairness of his proposal by limiting his proposed exemption to taxpayers who are all in the same tax bracket. Such a move, while mitigating the unfairness, would be an acknowledgment that a general exemption is unfair. Press accounts have not suggested that Mr. Sarkozy intends to introduce any such limitations on his proposal.

Although there are ways to reduce

somewhat the unfairness of the exemption for overtime pay, there is no way to eliminate that unfairness. In the end, the exemption causes individuals with the same money income to be taxed differently simply because one individual obtained the income from working overtime and the other earned the same amount from working normal hours. That basic unfairness is not removed or even mitigated by the existence of some inverse relationship between leisure and hours worked.

I have not tried to deal here with arguments that call into question the underlying principles of income taxation. In evaluating the Sarkozy plan on fairness grounds, I think it is proper to start with the assumption that France generally intends to impose an income tax on its taxpayers and is considering a limited departure from that goal in the special case of overtime pay. It is not contemplating the substitution of a consumption tax or an optimal tax or an endowment tax for an income tax. Those arguing for an adjustment to market income on account of some sacrifice of leisure or consumption opportunities or endowment are basically challenging the foundations of the income tax. Interesting issues, to be sure, but they are beside the point, in my view, in evaluating the merits of the Sarkozy plan.

Much of tax policy is deciding what differences in well-being don't matter in assessing tax liabilities. In an income tax, we properly ignore lots of things that might matter in making an overall assessment of an individual's economic position. For example, we ignore wealth, talent, and an ability to eat like a horse without gaining weight unless those attributes are used to produce market gains. For the reasons given above, I believe that different preferences for leisure and different sacrifices of leisure should not matter in assessing tax liability under an income tax. If I am right, then the Sarkozy plan is indefensible on fairness grounds.

A Reply to Professor McIntyre

By Richard L. Schmalbeck

It is far from clear that the Sarkozy plan would provide the stimulus he seeks, and unclear as well whether the plan would have the unfortunate effects on the French labor market that Professor McIntyre predicts. If adopted, the plan would be appropriately viewed as an experiment, and its consequences would require close monitoring. It may also require, as Professor McIntyre suggests, some complementary changes in the French labor laws (which might not be altogether bad).

But I do not share his pessimistic views on this. He seems to have in mind something of a zero-sum labor market in which overtime work by some must deprive others of opportunities to work. That is not impossible, but neither is it inevitable. Unemployment and underemployment usually result from a combination of constraints on market-clearing pricing (e.g., minimum wage laws), and a mismatch between the skills found in the labor pool and the skills sought by potential employers. So it is perfectly plausible that exempting overtime pay could yield higher total output at no loss in either employment or tax revenue. And the secondary effects of greater output—more disposable income and higher profits, for example—could actually lead to greater employment and revenue.

As for the equity issues, the tax policy advice of long-time Parisian Gertrude Stein—that a dollar is a dollar is a dollar—is the best background principle of taxability. But every tax system finds it wise to make some exceptions. In this case, the proposed exemption of overtime pay targets a decision point that is often a source of significant distortion. Relief of that distortion, rather than equity improvement, is the primary purpose. Still, its effects on taxpayer equity don't seem so bad.

I am not troubled, for example, by Professor McIntyre's comparison of Nicole and Louis. Nicole has extraordinary claims on her "leisure" time (by which we mean simply time not spent in market labor). She is already treated favorably by an income tax that does not impute income for the value of the services she provides to her own household. If her circumstances seem to merit further tax relief, it can be achieved by devices like child-care credits, personal exemptions, earned-income credits, and the like.

This example in fact highlights one important respect in which the Sarkozy proposal would improve equity: A person who works, say, ten hours of overtime each week has that many fewer hours available to provide services to his household. Had he provided those services to his household—perhaps generating higher levels of cuisine, garden care, and housekeeping—he would not have been taxed on the value thus generated. Exempting overtime achieves a similar tax-free result, producing more equitable treatment between those who provide marginal services at home, and those who provide marginal services in the market.

Finally, as I noted before, concern about the distributional consequences of this proposal is mitigated by the fact that high-income taxpayers—capitalists, actors, athletes, professionals, and executives—rarely work on an hourly basis, and would therefore be largely ineligible for the overtime exclusion.

So the first-order benefits of this proposal would be enjoyed largely by ordinary wage-earners roughly at or below the middle ranges of the income distribution. If it succeeds in stimulating the French economy, of course, the benefits would be more general. The French seem willing enough to experiment with their tax system—witness their on-again-off-again wealth tax over the last twenty years—and this experiment has more promise than most. ■

Health Savings Accounts: A Primer

By Jennifer R. Noel*

In the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, Congress permitted the creation of Health Savings Accounts ("HSAs") by adding section 223. In Notice 2004-50 and Rev. Rul. 2005-25, the Service provided further guidance on the requirements and administration of HSAs. Most recently, in the Health Opportunity Patient Empowerment Act of 2006 (included in the Tax Relief and Health Care Act of 2006), Congress significantly expanded the attractiveness of HSAs. The discussion below is based on the law in effect following the 2006 legislative changes and includes the 2007 inflation-adjusted amounts provided in Rev. Proc. 2006-53.

HSAs are attractive because taxpayers can deduct contributions to them and later withdraw funds tax-free to pay for current and future medical care costs. Taxpayers who wish to take advantage of these benefits must understand HSA terminology, deduction amounts, and other rules.

TERMINOLOGY

An HSA is a trust, created in the United States, to pay the qualified medical expenses of the account beneficiary. Section 223(d). Section 223(d)(3) defines account beneficiary as the individual on whose behalf the HSA was created. The governing instrument creating the trust must meet five requirements. First, contributions, other than rollover contributions, must be in cash and are subject to dollar limitations. The aggregate contributions for a year cannot exceed the sum of the maximum annual amount allowed for family coverage set forth in section 223(b)(2)(B) and any annual additional contribution amount that section 223(b)(3) allows for individuals who are 55 and older. Second, the trustee must be a bank, an insurance company, or some other person able to demonstrate to the satisfaction of the Service that the trust will be administered consistently with the requirements of section 223. Third, none of the trust assets may be invested in life insurance contracts. Fourth, the assets must not be commingled with any other property unless they are invested in a common trust fund or a common investment fund. Fifth, the trust document must provide that the individual has a nonforfeitable right to the account balance.

The section 223 deduction for a contribution to an HSA is available only to an eligible individual. An eligible individual is any individual who is covered under a high deductible health plan as of the first day of a month. As a general rule, the individual must not have other health insurance coverage that is provided through a plan that is not a high deductible health plan and that would provide overlapping coverage for any benefit offered by the high deductible health plan. Section 223(c)(1). Certain types of insurance coverage, however, do not automatically disqualify an individual from being eligible to fund an HSA. If the other insurance coverage falls within the definition of "permitted insurance," or if it provides coverage for accidents, disability, dental care, vision care, or long-term care, it will not make an individual ineligible for the purposes of an HSA. Section 223(c)(3) divides permitted insurance into three categories: (A) coverage that substantially relates to (1) worker's compensation injuries, (2) tort liabilities, (3) injuries occurring as the result of the ownership or use of specific property, or (4) similar liabilities as provided by regulations; (B) insurance for a specific disease or illness; or (C) hospitalization insurance that pays a specific benefit amount based upon the time spent hospitalized. As noted above, an eligible individual may be covered by permitted insurance in addition to a high deductible health plan.

Although they might otherwise qualify as eligible individuals, two groups of taxpayers cannot deduct contributions to HSAs: (1) individuals who are claimed as dependents on the tax return of another, and (2) individuals entitled to Medicare benefits. Section 223(b)(6)-(7).

A high deductible health plan is one that (1) has an annual deductible of not less than $1,100 for single coverage and (2) provides that the sum of the annual deductible and all other out-of-pocket expenses due under the plan, other than the premiums, for covered benefits does not exceed $5,500 for single coverage. Both single coverage amounts are doubled for family coverage, which is defined as any coverage other than self-only coverage. Those plans that fall within the definition of permitted insurance, or provide coverage for accidents, disability, dental care, vision care, or long-term care, are excluded from the definition of a high deductible health plan. Section 223(c)(2).

For insurance plans that provide both a network of providers and benefits for services provided by out-of-network providers, the annual deductible for out-of-network services will not be considered for purposes of determining whether the plan is a high deductible health plan. As a result, the annual out-of-pocket limitations for out-of-network services will not cause a plan to fail to qualify as a high deductible health plan because the limitation exceeds the maximum sum to be paid as provided in section 223(c)(2)(D)(i).

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TAX DEDUCTION

Taxpayers can deduct amounts contributed to HSAs in computing adjusted gross income. The ability to fund HSAs on a pre-tax basis is one of their attractions. In addition, contributions to HSAs do not affect taxpayers' ability to contribute to tax-favored retirement vehicles, thus allowing taxpayers to accumulate funds for the future payment of health-related expenses as well as retirement. Section 223(e) provides that an HSA is exempt from income tax unless it ceases to be qualified as an HSA or it becomes subject to the section 511 tax on unrelated business income.

Section 223(b) imposes limitations on contributions the taxpayer may make to an HSA and amounts the taxpayer may deduct with respect to those contributions. The general rule is that an individual who has established an HSA may deduct an amount equal to the sum of the monthly limitations for the months during which he or she is an eligible individual. The monthly limitation is determined based upon whether the eligible individual has single or family coverage under a high deductible health plan, and will equal one-twelfth of the lesser of the annual deductible or the inflation-adjusted monthly limitation. If the individual has single coverage, the inflation-adjusted monthly limitation for 2007 is $2,850. If the individual has family coverage, the inflation-adjusted monthly limitation for 2007 is $5,650. For taxable years beginning after December 31, 2006, the Health Opportunity Patient Empowerment Act has increased the potential deduction. A taxpayer who is an eligible individual during the last month of the taxable year will be treated as having been an eligible individual during each month of that year. Section 223(b)(8). Individuals who turn 55 before the end of the taxable year may contribute and deduct an additional amount, which increases from $700 for taxable years beginning in 2006 to $1,000 for taxable years beginning in 2009 and thereafter. The 2007 amount is $800.The following example explains how these rules operate. If an individual has a single coverage HSA and a high deductible health plan with a deductible of $1,500, the monthly limitation for the HSA would be $125 per month. If the deductible is increased to $3,000 per year, the monthly limitation for 2007 would be one-twelfth of $2,850, the maximum permitted, or $237.50 per month. If the individual is an eligible individual for December 2007, the maximum permitted contribution and deduction amounts would be the full $1,500 or $2,850. If the individual is 55 or older, the monthly limitation is increased by one-twelfth of the additional contribution amount. In 2007, this is one-twelfth of $800, or $66.67 per month.

> Taxpayers can deduct contributions to HSAs and later withdraw funds tax-free to pay for current and future medical care costs.

The monthly limitation is reduced by any amounts paid to a section 220 Archer MSA on behalf of the individual or contributed to another HSA for the individual in the same year. Thus, the aggregate amount any individual may contribute to one or more HSAs or Archer MSAs and deduct for tax purposes is limited to the amounts outlined above. Section 223(b)(5) provides additional limits for married individuals. If either spouse maintains family coverage, both spouses are treated as having such family coverage, with the lower of the two deductibles, if the two plans provide for different deductibles. The monthly deduction limitation is divided equally between the two spouses unless they agree on a different division.

Certain additional rules apply to HSAs. No deduction is available for rollover contributions pursuant to sections 223(d)(4)(A) and 219(d)(2). Contributions are deemed to be made on the last day of the preceding taxable year, provided they are made on account of that preceding taxable year and are made not later than the date on which the income tax return for such taxable year is due, excluding extensions therefor, pursuant to sections 223(d)(4)(B) and 219(f)(3). Section 223 is to be applied without regard to any community property laws pursuant to section 223(d)(4)(D). A custodial account may be treated as a trust for purposes of section 223 provided that the account is held by a bank or another person who demonstrates that the account will be appropriately administered, pursuant to section 223(d)(4)(E).

EMPLOYER CONTRIBUTIONS

Section 223(d)(4)(C) refers to sections 106(d) and 219(f)(5) regarding contributions by an employer to an HSA. Section 106(d) provides that if an employee is an eligible individual, a contribution made by an employer to the employee's HSA will be treated as employer-provided coverage for medical expenses under a qualified plan, as long as the amounts contributed do not exceed the limitations set forth in section 223(b). Section 219(f)(5) provides that if section 106(d) does not apply, employer contributions to an HSA are treated as compensation to the employee, includible in the employee's gross income for the taxable year in which the contribution is made, without regard to whether the employee is entitled to a deduction for the payment under section 219.

DISTRIBUTIONS AND ROLLOVERS

Distributions from an HSA that are used to pay qualified medical expenses (as defined in section 213(d)) are excluded from the gross income of the account beneficiary. One important limitation applies: the HSA must be established *before* a medical expense is incurred in order for such expense to be reimbursed from the HSA and excluded from the beneficiary's gross income.

Amounts that are withdrawn from an HSA but are not used for qualified medical expenses will be included in the beneficiary's gross income. If a beneficiary contributes amounts that exceed the annual contribution limits, but such excess contributions are returned before the due date of the beneficiary's income tax return for the year of contribution, the excess is not treated as a contribution or as a distribution. The returned amount itself is neither included in gross income as a distribution for non-medical purposes nor deductible as an HSA contribution. The net income attributable to the excess contribution must also be distributed with the excess contribution. The returned net income is included in gross income of the account beneficiary. If an excess contribution is made to an HSA and is not distributed from the HSA to the beneficiary prior to the above deadline, section 4973 imposes an additional six percent tax on the excess contribution.

The beneficiary will be subject to an additional excise tax equal to ten percent of any distributions that are not used for qualified medical expenses. The excise tax will not be imposed if a distribution is made after the beneficiary becomes disabled or dies, or after the beneficiary has reached the age for Medicare eligibility. Section 223(f)(4).

If an account beneficiary receives a distribution from an HSA and, within 60 days following the date of receipt, contributes the funds to a new HSA, those funds will be treated as a rollover contribution and will not be included in the beneficiary's gross income. An HSA beneficiary may make only one rollover during any one-year period, ending on the date that is one year after the date of receipt of the previous rollover distribution from an HSA. In other words, if an individual receives a distribution from an HSA on April 15, 2007, and rolls it into another HSA, any further distribution from an HSA for non-medical reasons prior to April 16, 2008, cannot be treated as a rollover contribution to an HSA.

Special rules apply for divorce and death. A transfer of an interest in an HSA that is made pursuant to divorce is not treated as a taxable event. The spouse who receives the interest is treated as having an HSA. When an account beneficiary dies, the HSA may be handled in one of two ways. If the designated beneficiary is the surviving spouse of the original account beneficiary, the HSA will be treated as if the surviving spouse had been the original account beneficiary. If someone other than the surviving spouse receives the deceased beneficiary's interest in the account, the account ceases to be an HSA as of the date of death. The account is then deemed to have been distributed for non-medical reasons. The amount is included in the recipient's gross income if the recipient is not the beneficiary's estate. The account is included in the deceased beneficiary's gross income for the beneficiary's last taxable year if the recipient of the account is the beneficiary's estate. If the deceased beneficiary incurred qualified medical expenses prior to death that were paid after death from the HSA, the amount included in the gross income of the recipient of the account is reduced by those payments. A recipient who must include the amount of the HSA in gross income can deduct the estate taxes attributable to the HSA's inclusion in the decedent's gross estate.

DISTRIBUTIONS TO HSAs FROM OTHER PLANS

The Health Opportunity Patient Empowerment Act added section 106(e) to cover distributions from flexible spending accounts and health reimbursement accounts to HSAs. One such distribution can be made before January 1, 2012, without causing the FSA or HRA to lose its status for purposes of sections 105 and 106. That act also added section 408(d)(9) to allow a limited trustee-to-trustee transfer from an individual retirement plan to an HSA. Only one such tax-free transfer may be made in the beneficiary's lifetime.

TERMINATION

If the beneficiary of an HSA engages in a prohibited transaction as defined in section 4975, the account will cease to qualify as an HSA as of the first day of the year in which the prohibited transaction occurs. Upon such termination, the account is deemed to have been distributed to the beneficiary. An account created by an individual and an account created by an employer for the same individual will be treated as two separate accounts. The effect of engaging in a prohibited transaction will apply only to the account that was directly affected. If the beneficiary of an HSA uses the account as security for a loan, that portion of the account that was used as security will be deemed to have been distributed to the beneficiary. The deemed distributions provided for in section 223(e)(2) are treated as amounts not used for qualified medical expenses, with the result that such deemed distributions will be subject to income tax and the additional ten percent excise tax discussed above.

CONCLUSION

The availability of HSAs provides an attractive planning opportunity for funding future health care costs. Individuals using HSAs can set funds aside on a pre-tax basis for health care expenses that may be incurred at any point following the creation of the account. Funds contributed to the HSA grow on a tax-deferred basis. Distributions, both before and after retirement, for health-related expenses are excluded from the taxpayer's gross income.

High-income individuals may find HSAs particularly attractive because contributions to HSAs are not subject to the section 213 medical expense deduction limitations, pursuant to which deductible medical expenses are limited to those that exceed 7.5% of AGI (and 10% of AGI for the alternative minimum tax). As a result, HSAs may be a useful planning tool available to individuals with the ability to create and fund them. ■

Guidance on Sections 403(b) and 409A

By David Pratt*

This article covers two compensation-related topics, the long-awaited final regulations under section 403(b) and compliance with section 409A. On September 10, 2007, the Service issued Notice 2007-78, which extends the section 409A document compliance deadline by one year, to December 31, 2008. The Notice does not extend the January 1, 2008, effective date of the final regulations.

SECTION 403(B): TAX-SHELTERED ANNUITY ARRANGEMENTS

Section 403(b) arrangements are tricky. They are misleadingly similar to the much more familiar 401(k) plans, but their governing rules differ from the 401(k) rules in many important respects. Some of these differences are historical; others reflect the characteristics of 403(b)-eligible employers (public educational institutions and 501(c)(3) organizations); some are puzzling even to 403(b) mavens.

On July 26, 2007, the Treasury Department issued comprehensive final regulations (T.D. 9340, 72 Fed. Reg. 41127) for the first time in more than 40 years. The regulations are generally effective for taxable years beginning after December 31, 2008, but there are several delayed effective dates and transition rules. The paragraphs below summarize major provisions of the regulations. The underlying theme is reducing differences between section 403(b) arrangements and other salary reduction arrangements.

1. Every 403(b) program (including governmental plans and other non-ERISA programs) must be maintained pursuant to a written plan that includes all of the plan's material terms and conditions [Treas. Reg. § 1.403(b)-3(b)(3)]. The written plan must include language covering the requirements of sections 401(a)(9), 401(a)(30), 401(a)(31) and (for annuities only) 401(g).
2. Certain 403(b) programs are exempted from ERISA by the statute, e.g., governmental plans and most church plans [see ERISA section 4(b)]. Certain other plans funded entirely by participant contributions are exempted by Department of Labor regulations [29 C.F.R. § 2510.3-2(f)], provided that the employer's involvement in the operation of the plan is appropriately limited. Comments on the proposed 403(b) regulations expressed concern that the increased employer involvement required would jeopardize this ERISA exemption. DOL Field Assistance Bulletin 2007-2 provides guidance on the relationship between this regulatory exemption and the new final regulations. Unfortunately, the FAB's facts-and-circumstances standard is not very helpful.
3. Under a 403(b) program (unlike a qualified plan), a participant is deemed to have compensation, for purposes of the section 415 limitations, for five years after his or her employment terminates. Accordingly, the employer may make non-elective contributions for all or part of that five-year period [Treas. Reg. § 1.403(b)-4(d)]. This five-year rule (1) does not apply to elective deferrals; (2) does not allow contributions after the individual's death; and (3) in the case of a non-governmental employer, requires compliance with the nondiscrimination requirements [sections 401(a)(4) and 410(b)].
4. Under a 401(k) plan, the employer can impose a minimum service requirement (not exceeding one year of service) before an employee is allowed to make elective deferrals. Under section 403(b)(12), all 403(b) programs (governmental or non-governmental), other than certain church plans, must satisfy a universal availability requirement rather than the Average Deferral Percentage test that applies to 401(k) plans. Subject to limited exceptions [see Treas. Reg. § 1.403(b)-5(b)(4)], all employees (including new employees) must be given an effective opportunity to make elective deferrals under the 403(b) program. The requirement generally applies separately to each common law entity [Treas. Reg. § 1.403(b)-5(b)(3)]. The regulations clarify the permissive exclusions for employees eligible under other plans, non-resident aliens, students, and employees who normally work fewer than 20 hours per week. The regulations do not continue other exclusions that were allowed under Notice 89-23, 1989-1 C.B. 654 (e.g., for union employees and visiting professors). Compliance with the universal availability requirement is very important, as it is a focus of Service audit activity: for example, the Service has recently expanded a project to ensure that eligible public school employees

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are allowed to contribute. See IR-2007-123, June 21, 2007.

5. Non-elective employer contributions to non-governmental 403(b) programs are subject to the same nondiscrimination requirements as qualified plans [sections 401(a)(4) and 401(m)]. The regulations do not extend the good faith reasonable compliance standard of Notice 89-23.
6. Some amounts held under a 403(b) program are subject to special distribution timing restrictions [sections 403(b)(7) and (b)(11)]. Amounts that are not subject to these restrictions may be distributed only after severance from employment or on occurrence of a stated event (e.g., a fixed number of years, attainment of a stated age, or disability). Treas. Reg. § 1.403(b)-6(b). Severance has a special meaning in this context. Treas. Reg. § 1.403(b)-6(h).
7. For the first time, 403(b) plan provisions may permit plan termination and (without participant consent) distribution or rollover of all assets. Treas. Reg. § 1.403(b)-10(a)(1).
8. New rules for transfers will supersede the rules of Rev. Rul. 90-24, 1990-1 C.B. 97 [Treas. Reg. § 1.403(b)-10(b)], and the regulations also include new rules for church retirement income accounts under section 403(b)(9) [Treas. Reg. § 1.403(b)-9(a)].
9. As under section 401(k), participants' elective contributions must be transferred promptly to the appropriate funding vehicle under the plan. Under Treas. Reg. § 1.403(b)-8(b), elective deferrals under a non-ERISA 403(b) program must be transferred within a period that is no longer than is reasonable for proper plan administration. If the 403(b) program is subject to ERISA, then the program is subject to the same rules that apply to ERISA-covered qualified plans.
10. Tax-exempt employers do not have owners, and section 414 does not specifically provide for tax-exempt entities to be aggregated in testing compliance with the rules governing tax-favored employee benefits. The new regulations provide aggregation rules for tax-exempt entities other than governments and certain churches. Treas. Reg. § 1.414(c)-5. These regulations apply in testing *all* employee benefits to which section 414(c) applies, not only in testing 403(b) programs. Aggregation is based on an 80% director/trustee common control test. Tax-exempts with a common exempt purpose may be aggregated permissively.

SECTION 409A: NON-QUALIFIED DEFERRED COMPENSATION

Section 409A was enacted as part of the American Jobs Creation Act of 2004, and was effective for compensation deferred after December 31, 2004, under a non-qualified deferred compensation program, as defined in the statute.

ADMINISTRATIVE GUIDANCE

On April 17, 2007, Treasury issued final regulations [T.D. 9321, 72 Fed. Reg. 19233], which generally follow the proposed regulations [70 Fed. Reg. 57930] issued in October 2005. For a discussion of the proposed regulations, see David Pratt, *The Not-So-Brave New World of Deferred Compensation,* ABA SECTION OF TAXATION NEWSQUARTERLY, Fall 2005, at 8. See also *Special Report: Section 409A: Annotation and Analysis,* PENSION & BENEFITS REPORTER, June 12, 2007, at 1402-1465 (an annotated version of the regulations, with comments by Daniel Hogans of Treasury and Stephen Tackney of IRS, the regulations' principal author).

Before issuing the final regulations, the Service had issued interim guidance (listed in the preamble to the regulations) clarifying the scope of section 409A and providing transition rules and delayed effective dates for bringing programs into compliance. The issuance of the final regulations does not restrict this transition relief. The final regulations are generally effective January 1, 2008. For periods before that date, the standards and transition rules set out in Notice 2006-79, 2006-43 I.R.B. 763, continue to apply. See also section XI of the preamble to the proposed regulations.

The preamble to the regulations contains detailed information about the following topics [regulations section number in brackets]: the definition of "nonqualified deferred compensation plan" [§ 1.409A-1(a)]; the applicability of section 409A to short-term deferrals, stock options and stock appreciation rights, arrangements between partnerships and partners, foreign plans, separation pay, and reimbursement and fringe benefit plans [§ 1.409A-1(a), (b)]; the definition of a "plan" [§ 1.409A-1(c)]; the definition of "substantial risk of forfeiture" [§ 1.409A-1(d)]; the rules governing initial deferral elections [§ 1.409A-2(a)]; the time and form of payment of deferred compensation [§ 1.409A-3]; the prohibition of accelerated payments [§ 1.409A-3(j)]; subsequent changes in the time and form of payment [§ 1.409A-2(b)]; nonqualified deferred compensation plans linked to qualified plans and other arrangements [§§ 1.409A-2(a)(9) and 1.409A-3(j)(5)]; and the statutory and regulatory effective dates [§ 1.409A-6].

Under the final regulations, the plan document(s) must generally be brought into compliance by December 31, 2007.

The final regulations do not address (1) the calculation and timing of amounts required to be included in income under section 409A; (2) reporting and withholding requirements (see IRS Notice 2006-100, 2006-51 I.R.B. 1109 for transition rules for 2005 and 2006); or (3) offshore trusts and arrangements with financial triggers, with respect to which taxpayers may continue to rely on Notice 2006-33, 2006-15 I.R.B. 754, until further guidance is issued.

On August 7, 2007, the Service issued answers to frequently asked questions relating to deferral of compensation by teachers. See TAX NOTES TODAY, 2007 TNT 153-17 (Aug. 8, 2007).

STATUTORY AMENDMENTS

The Pension Protection Act of 2006 amended section 409A to provide that if, during any "restricted period" with respect to a single-employer defined benefit pension plan of a plan sponsor, assets are set aside (directly or indirectly) in a trust (or other arrangement as determined by the Secretary of the Treasury), or transferred to such a trust or arrangement, for purposes of paying deferred compensation of an "applicable covered employee," such transferred assets are treated as property transferred in connection with the performance of services (whether or not such assets are available to satisfy the claims of general creditors) under section 83. The provision also applies if a nonqualified deferred compensation plan provides that assets will be restricted to the provision of benefits under the plan in connection with a restricted period of any defined benefit pension plan of the employer, or if assets are so restricted.

A restricted period is (1) any period in which a single-employer defined benefit pension plan of the plan sponsor is in at-risk status; (2) any period in which the plan sponsor is in bankruptcy; and (3) the period that begins six months before and ends six months after the date any defined benefit pension plan of the plan sponsor is terminated in an involuntary or distress termination.

Covered employees include the chief executive officer (or individual acting in such capacity), the four highest compensated officers for the taxable year (other than the chief executive officer), and individuals subject to section 16(a) of the Securities Exchange Act of 1934. An applicable covered employee includes any (1) covered employee of a plan sponsor; (2) covered employee of a member of a controlled group which includes the plan sponsor; and (3) former employee who was a covered employee at the time of termination of employment with the plan sponsor or a member of a controlled group which includes the plan sponsor.

If an employer provides directly or indirectly for the payment of any federal, state, or local income taxes with respect to any compensation required to be included in income under the rule, interest is imposed on the amount of such payment in the same manner as if the payment were part of the deferred compensation to which it relates. The payment is also subject to a 20% additional tax, and it is nondeductible by the employer.

OTHER RECENT DEVELOPMENTS

In Notice 2007-62, 2007-32 I.R.B. 331, the Service and Treasury announced plans to publish guidance which will apply the section 409A definition of substantial risk of forfeiture [Treas. Reg. § 1.409A-1(d)] to 457(f) plans. The section 409A definition is narrower than the section 83 definition.

The minimum wage legislation passed by the Senate earlier this year included a cap on the amount of compensation that could be deferred each year under a nonqualified plan. The cap was the lesser of (1) $1 million or (2) the employee's average annual earnings for the preceding five years. This proposal was dropped, but it may reappear.

CONCLUSION AND RECOMMENDATIONS

Section 403(b) plan sponsors and their advisors must consider the effect of the new regulations, and the changes that they will require to plan documentation and operational procedures. The 2009 effective date requires prompt action, particularly as many plan sponsors will need to make significant changes to their procedures and negotiate a new relationship with insurers and other providers.

Despite the best efforts of Treasury and the Service, the 409A rules are a morass, and compliance will be challenging for all affected employers. The 2008 effective date is uncomfortably close, and plan sponsors must (1) identify all affected plans, which will include many plans not commonly thought of as providing deferred compensation; (2) identify the changes to each plan that are required to bring the plan into compliance; (3) discuss the required changes with affected employees and corporate officials; (4) decide whether to amend or discontinue the plan; (5) prepare and execute the necessary documents; and (6) install procedures to ensure operational compliance.

A coalition of major law firms is requesting a one-year extension of the 409A compliance deadline, to December 31, 2008. Jeff Nash, *Heavyweight law firms to ask IRS for deferred comp plan delay,* FINANCIAL WEEK, Aug. 20, 2007, www.financialweek.com/apps/pbcs.dll/article?AID=/20070820/REG/70820010/-1/FWDailyAlert01. In a July 31, 2006, letter to congressional leaders, the ABA Section of Taxation requested a postponement of the effective date of section 409A, to consider narrowing its scope or repealing it, and wrote that "Congress has created a federal regulatory system that is largely unnecessary, will impose enormous administrative burdens on taxpayers, their advisers, employers and others, as well as on the IRS and Treasury, and is not a measured response to the underlying problems." This letter is available at http://www.abanet.org/tax/pubpolicy/2006/073106ircsec409altrtosenatecommittee.pdf. This conclusion is clearly correct and one can only hope that, on further consideration, Congress will realize, as it did with section 89, that the cure is worse than the disease. ■

Shrinking Boomer Social Security Retirement Benefits

By Francine J. Lipman*

In 2008, the oldest of 78 million baby boomers will celebrate their 62nd birthdays. Before they blow out their birthday candles, they will have considered and likely decided whether to elect to take early Social Security retirement benefits. For the next 20 years, a record number of seniors will face this and related retirement issues. The number of seniors will reach more than 70 million in 2030—20% of the U.S. population—with the number of new retirees hitting a record high in 2022 at almost 5 million.

Our aging population is an issue of global magnitude. The senior populations in the U.S. and the world are exploding. By 2050, the number of seniors will exceed the number of young people for the first time in the history of the world. Life expectancies are continuing to grow longer each year, with one year added about every decade. Not only are seniors living longer and healthier lives, but the fastest growth rate is in the 85+ year old category. At age 62, the average man, woman and couple have a life expectancy of 18, 21 and more than 25 years, respectively. The average person now spends one-third of their adulthood as a retiree.

While we are living longer and enjoying richer lives, there are striking changes on the horizon. Without thoughtful consideration these changes could hit you and your clients unexpectedly and adversely where it hurts, especially during the "golden" years—and that is in the wallet. The average replacement rate of Social Security benefits for earned income will decrease dramatically from a consistent 40% to less than 30% by 2030. The decrease will be even greater for higher income retirees. The replacement rate will drop because of a number of changes that are not known or understood by many boomers who are nearing retirement.

As tax professionals advising clients on a myriad of financial and business matters, we must be prepared to assist boomers with their fast-approaching retirement decisions. Social Security and Medicare are critical components of the boomer retirement package. Indeed, for two-thirds of all seniors Social Security retirement benefits (SSRBs), which currently average about $13,000 for individuals and $21,000 for couples, comprise more than one-half of retirement income. Therefore, as advisors we must understand the gritty details of Social Security so that we can assist them (and ourselves) with these critical decisions. This article provides an overview of issues on which we should be able to advise clients considering retirement.

SOCIAL SECURITY 101: TIMING IS EVERYTHING—EARLY, NORMAL OR DEFERRED RETIREMENT

During the earliest days of eligibility for SSRBs in the 1940s-50s, the average age at retirement was 68. In the decades since early retirement at age 62 was first introduced in 1961, the average retirement age has dropped dramatically. Today more than 60% of all eligible seniors elect to take their SSRBs at 62 and about 90% make this election before normal retirement age (NRA).

At the same time that more seniors have been electing early SSRBs, they

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have been living longer and healthier lives—thus receiving benefits for a longer period. Perhaps to discourage early retirement, Congress has increased NRA for seniors born after 1937. While NRA was 65 for decades, it has been slowly and steadily increasing and is now and will continue to be 66 for seniors born through 1954. The NRA (for individuals born in years 1955-1959) will increase by two months every year up to 67 (for individuals born in 1960 and thereafter).

If an individual elects to take her SSRBs before attaining her NRA, her benefits will be reduced permanently. For boomers retiring at age 62 in 2008-2016, the reduction percentage will be 25% of SSRBs if NRA is 66. There will be further benefits reductions (at a rate of about .83% for each year)—for those retiring at age 62 in 2017-2021. Beginning in 2022 (the year that the greatest number of boomers will reach 62), SSRBs will be reduced by 30% for all age 62 early retirees. Because this reduction percentage was only 20% for early age 62 retirees born in 1937 and earlier, practitioners and clients may not be conversant with the significant limitations on the horizon. In addition to considering these reductions, computations must also factor in a potential benefits increase: SSRBs are increased permanently by eight percent for each year (up to age 70) a senior defers taking her SSRBs beyond her NRA.

The examples below assume NRA-SSRBs of $1,500 per month for an individual born in 1960. Early retirement is defined as 62 years and one month (the earliest possible retirement date for this purpose); NRA is age 67; and deferred retirement is age 70. The potential benefits are shown for a married couple, one member of which receives spousal benefits rather than benefits based on his/her own work record.

Early Retirement: The monthly benefit would be reduced permanently to $1,050 (versus $1,200 in 1999) and to only $488 (versus $563 in 1999) for spousal retirement benefits, a $1,538 monthly total. **Annual Combined SSRBs: $18,456.**

Normal Retirement: The couple would receive SSRBs of $1,500 and $750, or $2,250 each month. **Annual Combined SSRBs: $27,000.**

Deferred Retirement: SSRBs would be increased to $1,860 and $930 for spousal retirement benefits or $2,790 for the deferred retired couple. **Annual Combined SSRBs: $33,480.**

Comparative Analysis: The differences between these elections are meaningful. Indeed, there is more than an 81% increase between the deferred retirement as compared to the earliest retirement amount—*more than a $15,000 increase each year!* While these examples are notable and the foregoing discussion relevant, they are not comprehensive. The question regarding when to begin SSRBs must include a thoughtful consideration of work opportunities and alternatives.

SOCIAL SECURITY EARNINGS LIMIT: TO WORK OR NOT TO WORK

Almost 90% of all retirees draw SSRBs before NRA, but some of these individuals continue to work. Recent surveys indicate that most boomers plan to work longer than their predecessors. About 80% of boomers surveyed have indicated that they plan to work beyond early retirement age. This is not surprising given increased life expectancies, better health, and safer, less strenuous work environments. An individual should retire at age 74 (78 in 2065) to mirror the average retirement age of 68 that existed before Congress provided an early retirement option.

For most retirees, SSRBs do not even come close to replacing a worker's earnings. Therefore, from a pure cash flow perspective it will always be preferable to work versus to stop working and rely on SSRBs. However, the decision to elect to draw SSRBs does not preclude a worker from continuing to work. Unfortunately, working and drawing SSRBs before NRA has significant implications regarding the amount of SSRBs a retiree can retain.

In most cases, a retiree should not elect to draw SSRBs before NRA if she plans to continue working full-time. If a retiree's earnings exceed a certain threshold amount SSRBs can be reduced entirely. From age 62 to NRA, a retiree's SSRBs are reduced if she earns more than approximately $13,000 (indexed annually). She will lose $1 of SSRBs for each $2 of earnings in excess of this limit. Therefore, an average retiree receiving $10,000 in early SSRBs would lose all of her benefits if she earned $33,000 or more. Lost SSRBs are typically withheld from future SSRBs, but they do increase gross SSRBs after a retiree reaches NRA.

Retirees who work continue to pay Social Security and will possibly increase future SSRBs whether or not they have elected early SSRBs. That is because SSRBs are based upon the highest 35 years of earnings. Therefore, SSRBs should continue to increase every year that a retiree works, especially if her earnings increase every year (at a rate greater than wage inflation) or if she did not already have 35 years of earnings.

Another important factor that often weighs into the "to work or not to work" question is health care coverage. Retirees qualify for Medicare coverage at age 65 even though NRA now exceeds age 65. This is the case whether or not a retiree elects early SSRBs. In addition to enhanced cash flow and potentially increased future SSRBs, continuing to work could provide valuable health care coverage for the retiree and her family.

MEDICARE PART B PREMIUMS: MEANS TESTING

As most boomers well understand, health care costs have been and are continuing to skyrocket. For several years, Medicare premiums have been increasing at a greater rate than SSRBs have been increasing. Over the past five years, Medicare Part B premiums have

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skyrocketed 60%, while SSRBs have increased only 14%. In 2008, SSRBs are estimated to increase a mere 1.5% while Medicare Part B premiums will jump 17%. Fortunately for retirees federal law has provided that Medicare beneficiaries have paid a maximum of 25% of actual Medicare costs and after-Medicare SSRBs could not decrease from the prior year.

Beginning in 2007, Congress is shifting additional Medicare costs to higher income seniors. In 2007, 1.2 million (that is, three percent of all) beneficiaries will pay Medicare Part B premiums that are greater than the standard monthly amount. The increased premiums are based on modified adjusted gross income (MAGI, which includes tax-exempt interest) from recent tax return information provided by the IRS (generally 2005 MAGI for 2007 premiums and 2006 MAGI for 2008 premiums, etc.). If certain life-changing events (e.g., death, divorce or disability) cause this presumed income level to be overstated, retirees can provide information to rebut this presumption. If they are not able to convince the Social Security Administration that a lower level of income is appropriate, retirees can appeal an adverse decision.

The Medicare Part B premiums for higher-income individuals will increase every year through 2009—to 35% ($80,001 to $100,000 MAGI single) and up to 80% (more than $200,000 MAGI single) of actual Medicare costs. For 2007, the standard monthly Medicare premium amount is $94. The increased premiums range from $106 (for $80,001 to $100,000 MAGI single, with doubled ranges for married couples) to $161 per month (for single individuals whose MAGI exceeds $200,000). Based upon 2008 Medicare premium projections, beneficiaries in these MAGI ranges will pay monthly Medicare premiums of approximately $140 and $270 in 2008 and $180 and $400 in 2009, respectively, as compared to the 2008 and 2009 projected standard premium amounts of $109 and $128. These radically higher Medicare premiums will reduce net SSRBs dramatically.

TAXABLE SOCIAL SECURITY BENEFITS

In addition to higher Medicare premiums, many boomers will face higher tax costs on their SSRBs. Since 1983, SSRBs above certain threshold amounts are subject to federal income tax. Presently, up to 50% of SSRBs are included in taxable income if a beneficiary's MAGI plus one-half of SSRBs exceeds $25,000 ($32,000 for married filing jointly, $0 married filing separately couples). If that total exceeds $44,000 ($54,000 for married filing jointly couples, $0 for married filing separately couples), then up to 85% of SSRBs are included in taxable income.

Notably, SSRBs increase annually in dollar amount, because they are indexed for inflation, but the gross income inclusion thresholds have not been indexed for inflation since 1983. As a result, more and more seniors are paying taxes on their SSRBs. This tax cost meaningfully reduces after-tax SSRBs and will continue to do so—capturing more and more seniors for larger amounts every year.

CONCLUSION

Millions of senior boomers will face critical retirement decisions over the next 20 years. Tax professionals can be of great assistance with these decisions. Recent and evolving changes in NRA and Medicare premiums and increased exposure to tax costs have reduced the net cash flow many senior boomers will enjoy from SSRBs. Unfortunately, because of the overall lack of transparency in the Social Security benefits formula and the complex interplay of continued work, Medicare, taxes, and the various timing options, many boomers are unable to make informed decisions about critical retirement matters. Sadly, uninformed early retirement decisions can lead to devastating circumstances when the senior is most vulnerable—with few or no alternatives in the increasingly experienced post-80 years. As informed tax professionals we should assist our boomer clients with their retirement decisions today so that when they (and we) are 84 (Sir Paul almost had it right) the retirement years are truly golden. ■

Tax Section Survey Report on Independence of IRS Appeals

The Section recently surveyed its membership to determine their experience relating to the perceived independence of the Internal Revenue Service's ("IRS" or "Service") Appeals Division ("IRS Appeals" or "Appeals"). The Committee on Administrative Practice and a "Blue Ribbon" panel of members developed a seven-page survey instrument to solicit opinions from Section members who have had experience with Appeals in the recent past. This survey covered the independence of the IRS Appeals process in the examination, collection, and enforcement functions. More than 560 Section members responded to the initial evaluation questions in the survey, and they provided over 70 pages of comments about the positive and negative aspects of their recent experiences with IRS Appeals.[1] The results of the survey appear in the 108-page Survey Report, which is now available on the Section's website at www.abanet.org/tax. This article constitutes the executive summary of the report.

One component of the survey gave respondents the opportunity to evaluate a series of general statements about the Appeals process. The key responses are summarized below:

- On a positive note, 73.1% of the respondents believe that Appeals Officers are generally fair.
- Three quarters of the respondents perceive Appeals Officers to be generally well trained in tax law and procedure.
- About 73.5% of the respondents expressed their belief that Appeals Officers are generally well trained in how to interact with taxpayers and representatives.

There is agreement across a substantial component of the respondent pool with regard to perceptions that certain recent changes in the structure and procedures of IRS Appeals have had a negative effect on that office's independence or appearance of independence. The following key responses are noteworthy:

- Almost 80% of the respondents expressing an opinion believe that Appeals involvement in recent IRS tax shelter settlement initiatives, such as the Executive Stock Option tax shelter, makes Appeals less independent.
- About 62% believe that Appeals Officers who are located at the same physical location as compliance personnel are less independent than Appeals Officers who are located at a different (non-co-located) offices.
- Over half of the respondents expressing an opinion on these issues think that Appeals Officers who are located at campuses (formerly "service centers") are less independent than local Appeals Officers, and that Appeals involvement in recent alternative dispute resolution processes, such as the Fast Track Mediation or Fast Track Settlement, makes Appeals less independent.

Interestingly, with regard to the Fast Track programs, about three quarters of the relatively small number of tax practitioners who have actually participated in either the Mediation or Settlement program reported their perception that these are worthwhile programs. This suggests that consideration should be given to making these programs more accessible.

The survey tested perceptions about the Appeals process in the context of four different types of matters—examination appeals, collection due process ("CDP") hearings, appeals from offers in compromise ("OIC") or non-CDP cases, and innocent spouse appeals. Interestingly, there were differences in perceptions across these different case types.

It is interesting to note that some of the findings generally mirror those described in the Report of the Treasury Inspector General for Tax Administration issued in 2005.[2]

In response to the question, "how satisfied were you with the independence Appeals had from the people who proposed adjustments," about 60% of the respondents reported some level of satisfaction.

The many comments provided by the survey respondents illuminated the reasons for their positive or negative perceptions of their recent experiences with Appeals. Most of the comments, both positive and negative, focus on Appeals personnel issues. Positive comments cite the willingness of Appeals personnel to listen to the arguments presented, the level of preparation exhibited by the Appeals Officers, and the ability of Appeals personnel to reach conclusions that recognize the elements of each individual

[1] The Tax Section gratefully acknowledges the outstanding efforts of Joanne Martin, Senior Research Fellow of the American Bar Foundation.

[2] "The Overall Independence of the Office of Appeals Appears to be Sufficient," Report of the Treasury Inspector General for Tax Administration (Ref. No. 2005-10-141) September 9, 2005 ("TIGTA Report").

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case. The negative comments touch upon concerns with Appeals Officers who seem unable to reach a decision without consulting the IRS National Office; the influence of industry specialists or other experts to the detriment of the independence of the Appeals Officers; perceptions that Appeals Officers who come up through the ranks of revenue officers or examination agents bring with them the attitudes of their previous positions rather than attitudes more appropriate to an appellate official; and that competent, experienced Appeals Officers are retiring, ceding the arena to individuals who are not as well trained. In addition, there are substantial concerns about delay in resolution caused by lost files, heavy caseloads, and lack of timely communication. ■

NEWS BRIEFS

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LAW STUDENT TAX CHALLENGE

Now in its seventh year as an ongoing project of the Tax Section's Young Lawyers Forum, the 2007-2008 Law Student Tax Challenge is underway. Designed to stimulate and reward law student interest in and knowledge of the tax law as it applies to "real life" tax planning situations, this nationwide competition is open to law students attending any ABA-accredited law school.

Teams are initially evaluated on two criteria: a memorandum to a senior partner and a letter to the client explaining the result. Based on this written work product, 6 teams from the J.D. Division and 4 teams from the LL.M. Division receive a free trip to the Section's 2008 Midyear Meeting, January 17-19, at the Loews Lake Las Vegas Resort, where they will defend their submissions before a panel of some of the country's top tax lawyers.

Written submissions are due November 12, 2007. This year's problem focuses on a like-kind exchange and issues related to the formation of a partnership. To review the contest rules and this year's problem, visit www.abanet.org/tax/lstc.

FALL MEETING MATERIALS AVAILABLE ONLINE

Did you miss the Joint Fall CLE Meeting in Vancouver? You can still benefit from over 160 papers that were presented at the meeting by logging on to the Tax Section's website. As a benefit of membership, Section members can view and search materials from the Fall Meeting, as well as other Section Meetings at: http://www.abanet.org/tax/commonline/.

FALL MEETING SPONSORS–THANK YOU

The Tax Section would like to thank the following sponsors of the 2007 Joint Fall CLE Meeting:

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PRO BONO OPPORTUNITY IN WASHINGTON, DC

The Pro Bono Committee of the Tax Section will be implementing a pilot program for member volunteers in the Washington, DC area to assist in the training of VITA volunteers to prepare returns on military bases in the Metropolitan Washington, DC area. Tax Section volunteers will not be asked to prepare returns themselves, but instead will be asked to train the preparers. Because the pilot is limited to the Washington area, we are only soliciting volunteers from that region. To learn more about this pro bono opportunity, check the Section web site at www.abanet.org/tax.

National Conference on the Tax Gap

By Ellen April[*]

On June 21-22, the Section, along with the American Institute of Certified Public Accountants, the American Tax Policy Institute, the Tax Executives Institute, and the American College of Tax Counsel, sponsored the National Conference on the Tax Gap. It brought together government officials, academics, and private practitioners, from both the United States and abroad, with the goal of helping policymakers address this difficult and important issue.

As those in attendance learned, additional revenue from increasing compliance is not likely to be great and will not close the looming budget deficit. Nonetheless, increased compliance efforts will have other benefits, including reducing concerns about the fairness of the tax system and helping to maintain the existing high level of compliance. Many of the speakers urged tax administrators to view themselves as providers of services to citizens seeking to understand and comply with the law as well as enforcers of the law seeking to punish those who seek to evade it. To that end, they urged policymakers to pay more attention to the psychological factors that influence compliance.

Dennis Zimmerman, Project Director of the American Tax Policy Institute, who served as the Conference's Reporter, has identified two themes related to the cash sector of the economy. First, while the level of compliance overall is surprisingly high, this sector is the major source of non-compliance. Second, better data, particularly increased information reporting, are key to closing the tax gap, but the compliance costs are high for obtaining such information for the cash sector.

The conference was organized into five panels. The first described the tax gap, including its size and how it is estimated. The second explored the key determinants of compliance and non-compliance by examining theoretical, survey, and experimental research conducted over the past 35 years. The three final panels discussed possible approaches to closing the gap. The five panel presenters and commentary on their presentations are discussed below.

DEFINING THE TAX GAP

Dr. Eric Toder of the Urban Institute opened the conference with his paper, "What Is the Tax Gap?" He defined it as the difference between tax liability under current federal tax law and taxes paid. The gross tax gap for 2001 was $345 billion, about 16% of federal tax liability. The tax gap has three main components—nonfiling, underreporting and underpayment. The underreporting gap at $285 billion is by far the largest of the three and poses the most challenging methodological issues. It is primarily attributable to individual taxpayers with income from businesses, rent and royalties, farms, partnerships and other flow-through entities.

While the Service has developed highly sophisticated techniques for estimating the tax gap, there are serious measurement issues. First, estimates of the tax gap's size rely on statistical estimates of the amount of underreported income. Second, individual measures of the tax gap capture the amount of tax avoidance from flow-through entities very incompletely. Third, the Service makes no adjustment for undetected overpayment of tax liability. Fourth, some components of the tax gap measure, especially estimates of the corporate income tax gap and the employer portion of the employment tax gap, are

Dr. Toder explained that the tax gap has three main components—nonfiling, underreporting and underpayment. The underreporting gap at $285 billion is by far the largest of the three and poses the most challenging methodological issues. It is primarily attributable to individual taxpayers with income from businesses, rent and royalties, farms, partnerships and other flow-through entities.

[*] Loyola Law School, Los Angeles, CA. Professor Aprill wrote this article in her role as Vice Chair–Communications of the Section.

seriously out of date. Fifth, more work needs to be done on measuring the tax gap resulting from sophisticated tax avoidance strategies.

Dr. Toder concluded that the tax gap measure is a reasonably good indication of the gap's order of magnitude, but that it was a poor measure for measuring trends, evaluating Service performance, or determining the best enforcement strategies.

Professor Jay Soled of Rutgers Business School, and Dr. Mark Mazur of the Service commented on Dr. Toder's paper. Professor Soled emphasized that the government needs to know not only what the tax gap is, but also why it wants to know and how the size can be reduced. Dr. Mazur noted that making a tax gap estimate requires both art and science. Some estimate, even with uncertainty, is better than no estimate.

In one study, among those who received a letter stating that the tax returns that they were about to file would be closely examined, low and middle-income taxpayers increased compliance, but high-income taxpayers reduced compliance.

COMPLIANCE AND NON-COMPLIANCE

Dr. John Hasseldine, Director of the Tax Research Institute of Nottingham University Business School, presented a paper that he and Dr. Peggy Hite of Indiana University had done on the key determinants of compliance and non-compliance. He reminded the audience that the objective for policymakers is to change noncompliant taxpayers to compliant ones. Thus, policymakers need to understand taxpayers' behavioral responses in order to evaluate new enforcement initiatives. Factors influencing behavior include socioeconomic and demographic considerations, financial self-interest, social sanctions, social commitment, and the influence of tax preparers. Extensive research has shown that tax accountants and preparers (including software) play a key role in compliance.

Drawing on the compliance literature, he described Australia's pyramid of responsive regulation. Instead of "command and control" with heavy reliance on penalty provisions, the Australian Tax Office now uses a compliance model that opts first for low cost persuasion and escalates to options more oriented toward deterrence as less interventionist strategies fail. The Australian Tax Office also works closely with tax preparers.

Dr. Hasseldine discussed a field experiment from Minnesota, to measure the effectiveness of four strategies to increase voluntary compliance. Among those who received a letter stating that the tax returns that they were about to file would be closely examined, low and middle-income taxpayers increased compliance, but high-income taxpayers reduced compliance. (Others at the conference speculated that one explanation might be that high income taxpayers viewed the likelihood of audit as a signal to make a low initial offer to begin a bargaining process.) Following the Minnesota experiment, Dr. Hasseldine participated in a British national field experiment to test five different treatment letters against a control group. In this experiment, every type of treatment letter showed a significant effect on improving compliance. An important lesson from these and other studies, Dr. Hasseldine concluded, is that no one approach will be effective for all taxpayers.

James Wetzler of Deloitte Tax LLP noted that in evaluating the costs of enforcement, we must consider the benefits of federal efforts for state tax enforcement, the costs enforcement imposes on the private sector, and the spillover benefits from current enforcement on future voluntary compliance. David Lifson of Hays & Company LLP emphasized two principles he believes should shape our tax law. First, people do not obey laws that they don't understand and, second, people don't disobey laws if they think they will get caught. Lennart Wittberg of the Swedish Tax Agency reminded the audience that the goal of tax administration is to prevent tax evasion rather than to detect it and that a customer-oriented approach is needed to achieve this goal.

BEHAVIORAL OPTIONS

Professor Joshua Rosenberg of the University of San Francisco School of Law examined behavioral options for narrowing the tax gap. Most people have definite emotional reactions to taxes, specific cognitive frames around taxes, and learned but unconscious behavioral reactions that can significantly affect their tax-paying or tax-evading behavior. For many Americans, these influences are negative, and they try to avoid their share of taxes in order not to be seen as a fool for complying.

Economic incentives also play a role, given the substantial gains for avoiding taxes. In addition, tax preparers generally see their job as minimizing tax liability. Low audit rates play a role as well. Moreover, tax evasion is perceived as different from other crimes because the victim is not an individual for whom we have empathy, but the huge impersonal entity we know as the government. It is difficult to see the adverse effects of non-compliance, namely, services that are not provided or higher tax rates. All these factors distort the perspective toward taxes.

Professor Rosenberg identified three problems that encourage policymakers to view tax laws differently from other kinds of laws. First, there is an illusion of precision that frees policymakers from the difficulties of exercising judgment to make hard decisions among conflicting goals. Second, analysis of tax laws undervalues the benefits of taxation. Third, analysis of tax laws ignores the effect of taxes on encouraging desired behaviors and penalizing undesirable conduct.

Nonetheless, he believes that change is possible if tax policy and administration take the nature of human interaction into consideration. Taxpayers must understand more about the tax law and tax administrators must understand more about taxpayers' behavior, feelings, and motivations.

Professor Rosenberg suggested imagining an ideal cycle of actions and reactions about taxes. In such a world, we would reward assistance in tax compliance rather than encourage complicity in tax avoidance. Tax officials would use the media to inform taxpayers and establish compliance as a norm. In this a world, we might, for example, require reporting by consumers, merchant bankers and credit card companies and even encourage individuals to volunteer to report all their accounts for the Service to compute their taxes.

In his commentary, Dr. Alan Lewis of the University of Bath Department of Psychology noted that behavior can shape attitudes as well as attitudes shaping behavior. While many do try to evade taxes, we have a very high rate of compliance, and we do not want to introduce rules that in fact encourage evasion by undermining the intrinsic motive to comply. Janet McCubbin of the Service was intrigued by the idea of taxpayers voluntarily providing their records to the Service and suggested that this proposal and the idea of rewarding taxpayers for good behavior merited further study.

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RESEARCH STUDIES

Dr. James Alm of Georgia State University School of Policy Studies reviewed theoretical, empirical and experimental research on why people do and do not pay taxes. The basic theoretical model is an economic one, which posits that an individual pays taxes out of fear of punishment. However, rates of compliance far exceed the level such a model would predict, and researchers have begun to enrich the economic model with psychological considerations. These include the fact that individuals act as if the probability of audit is much higher than its actual probability or the impact of social norms on behavior.

Empirical analysis suffers from the lack of reliable information on taxpayer compliance. Even the best data do not reveal all underreported income, capture nonfilers, or identify honest errors. To combat these problems, researchers have undertaken various approaches, such as using aggregate rather than individual measures or using surveys. Dr. Alm interprets the empirical studies as being consistent with a significant, though diminishing, deterrent effect of higher audit rates. There also seems to be some spillover effect in that audits produce an increase in compliance independent of revenues generated directly from the audits and penalties themselves. In contrast, tax amnesties seem to generate relatively little revenue or spillover effect.

He views laboratory experiments, yet another approach, as showing that a higher audit rate leads to greater compliance, that people tend to overweight the probability of an audit, that fines have small effects on compliance, that public disclosure of non-compliance can be effective as a deterrent, and that the compliance behavior of others has an effect. Other experiments show that individual rewards, such as eligibility for a lottery if an audit indicates full reporting, provide significant inducement for greater compliance. Experimental studies have also demonstrated the important role of social norms. Nonetheless, various methodological difficulties require that the results from laboratory experiments be used with care.

The results of these various types of research and experience in other countries suggest to him that the traditional paradigm, in which taxpayers are viewed and treated as potential tax criminals, needs to be supplemented with a service paradigm in which tax administrators see themselves as a

provider of services to taxpayer-citizens.

Commentator Claus Johannessen of the Danish Ministry of Taxation urged a multifaceted approach to increase compliance. As in the Australian regulatory model, tax administrators should distinguish different categories of taxpayers. Debbie Langsea of the California Franchise Tax Board described how California had increased revenue by using a multi-faceted plan that combined soft approaches with enforcement, including publishing the names of non-compliers. Commentator Lawrence Gibbs of Miller & Chevalier remarked that because the Service is not likely to get more funding, it will have to prioritize and to continue being creative in using its resources.

THE CASH ECONOMY

Professor Joseph Bankman of Stanford Law School focused on the cash economy. It is important to remember that, on the assumption that after-tax returns are equal in the cash and non-cash sectors, the practice in the cash sector of not paying its full share of taxes means a lower pre-tax return on investment in that sector. In addition, we are reluctant to treat tax evasion in the cash sector as a significant crime for a number of reasons. Consumers benefit from the lower prices in the cash sector; many in the sector work hard, take risk, and have low incomes; underreporting is accepted as the norm.

Experience from other countries may offer some useful ideas. Several countries have tried to reduce the cash economy by subsidizing credit and debit cards. The most prevalent approach to cash sector evasion is to enter consumers who comply with reporting requirements in a government-sponsored lottery.

Professor Bankman urged caution in considering third party reporting, an approach often recommended. Third-party reporting for individuals is unlikely to generate numbers that can be electronically (and thus inexpensively) checked by government and thus serve as a basis for audit. Third-party reporting of business-to-consumer transactions, such as requiring consumers to report provision of services in excess of $600, would improve compliance but impose significant compliance-related costs.

Any expanded third-party reporting envisions additional audits, and there is no way to reduce the cash sector tax gap without more audits. Yet political opposition to more audits and higher penalties is widespread. Although compliant taxpayers would benefit from such increased enforcement, they fear that the government will not limit its audits to those cases in which there is a high level of evasion and a high level of payoff from auditing. Any significant increase in audit rates will require us to overcome this skepticism as to Service motives and efficiency. Professor Bankman closed by suggesting that we consider at least a partial reimbursement for audit expenses for taxpayers who are found to have paid substantially all of their tax liability.

In her commentary, Pamela Olson of Skadden, Arps, Slate, Meagher & Flom LLP reminded the audience that, based on past history, Congress is unlikely to adopt approaches to the tax gap that intrude upon taxpayers or require substantial recordkeeping. Simplification of tax laws would help the Service target its efforts. Jeff Hoops of Ernst & Young argued that there are large cash-based businesses that could and should be targeted for enforcement. He believes that the best option is to increase the Service's budget to hire and retain more experienced auditors. The comments of Hank Gutman of KPMG LLP summarized succinctly many points made during the conference: There is no silver bullet to addressing the tax gap. We should take small, coordinated steps using a variety of techniques.

CONCLUSION

In sum, the conference adopted a multidisciplinary approach by drawing upon economics, sociology, statistics, and psychology. The examination of this serious topic was not without humorous moments. Dr. Alm, in discussing non-financial penalties, pointed to a city in India that sent drummers to the homes of people who had not paid their property taxes with instructions to beat their drums around the clock until the delinquent taxes were paid. Dr. Hasseldine told about the effect of social norms on one individual. This taxpayer sent a letter to the revenue department: "I can't sleep because I cheated on my taxes. Here is $1500. If I still can't sleep, I will send you the rest." ■

According to Professor Bankman, experience from other countries may offer some useful ideas. Several countries have tried to reduce the cash economy by subsidizing credit and debit cards. The most prevalent approach to cash sector evasion is to enter consumers who comply with reporting requirements in a government-sponsored lottery.

Boxscore

Since July 2007, the Section has coordinated the following government submissions, which can be viewed and downloaded free of charge from the Section's website at www.abanet.org/tax/pubpolicy.

SUBMISSIONS AND COMMENTS ON GOVERNMENT REGULATIONS, ADMINISTRATIVE RULINGS, ABA POLICY and BLANKET AUTHORITIES*

TO	DATE	CODE SECTION	TITLE	COMMITTEE	CONTACT
Internal Revenue Service	8/31/07	1367	Comments on Proposed Regulations Under Section 1367 of the Internal Revenue Code Regarding the Treatment of Open Account Debt of S Corporations	S CORPORATIONS	Kevin D. Anderson
Internal Revenue Service	8/20/07	various	Comments in Response to Notice and Request for Comments on Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return	ESTATE AND GIFT TAXES	Carmen Irizarry-Díaz
House Committee on Ways and Means	8/6/07	501(c)(3)	Comments in Response to the Request of the Subcommittee on Oversight of the Ways and Means Committee Regarding the Provisions of the Pension Protection Act of 2006 Affecting Tax Exempt Organizations	SECTION OF TAXATION	Section of Taxation
Internal Revenue Service	8/1/07	509(a)(3)	Comments in Response to IRS Notice 2007-21 on Treasury Study on Donor Advised Funds and Supporting Organizations	EXEMPT ORGANIZATIONS	LaVerne Woods
Internal Revenue Service	7/24/07	2053	Comments Concerning Proposed Regulations Relating to Deductions for Claims Against an Estate Under Section 2053	ESTATE AND GIFT TAXES	Benjamin G. Carter
Internal Revenue Service	7/10/07	n/a	Comments on Proposed Regulations Relating to Payment In Lieu of Taxes Under Section 1.141-4 of the Treasury Regulations	TAX EXEMPT FINANCING	Linda B. Schakel, Clifford M. Gerber
Internal Revenue Service	7/2/07	6159	Comments on Proposed Regulations Related to the Payment of Tax Liabilities in Installments	LOW INCOME TAXPAYERS	Kamran Idrees, George Willis

*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 | www.abanet.org/tax/calendar

DATE	PROGRAM	ABA INFORMATION
Nov. 1-2, 2007	**PHILADELPHIA TAX CONFERENCE** Loews Philadelphia Hotel – Philadelphia, PA	Tax Section **www.abanet.org/tax** | 202.662.8670
Nov. 8, 2007	**TAX CLE ON THE ROAD - MANAGING A TRANSFER PRICING CONTROVERSY** – Houston, TX	Tax Section **www.abanet.org/tax** | 202.662.8670
Nov. 9, 2007	**TAX CLE ON THE ROAD - MANAGING A TRANSFER PRICING CONTROVERSY** – Dallas, TX	Tax Section **www.abanet.org/tax** | 202.662.8670
Nov. 29-30, 2007	**TAX EXEMPT CHARITABLE ORGANIZATIONS MARRIOTT AT METRO CENTER** – Washington, DC	ALI-ABA **www.ali-aba.org** | 800.CLE.NEWS
Dec. 5, 2007	**"LAST WEDNESDAY" CLE TELECONFERENCE – COPING WITH THE NEW RETURN PREPARER STANDARDS**	ABA Service Center **www.abanet.org/cle** | 800.285.2221
Dec. 6-7, 2007	**24TH ANNUAL NATIONAL INSTITUTE ON CRIMINAL TAX FRAUD** Hotel Nikko – San Francisco, CA	ABA Service Center **www.abanet.org/cle** | 800.285.2221
Dec. 10, 2007	**LOW INCOME TAXPAYER CLINIC (LITC) WORKSHOP** Hyatt Regency Capitol Hill – Washington, DC	Tax Section **www.abanet.org/tax** | 202.662.8670
Dec. 19, 2007	**ABA CONNECTION TELECONFERENCE: CURRENT DEVELOPMENTS IN TAX**	ABA Service Center **www.abanet.org/cle** | 800.285.2221
Jan. 30, 2008	**"LAST WEDNESDAY" CLE TELECONFERENCE**	ABA Service Center **www.abanet.org/cle** | 800.285.2221
March 9-14, 2008	**ABA/IPT TAX SEMINARS: INCOME TAX, SALES/USE TAX, PROPERTY TAX** The Ritz-Carlton – New Orleans, LA	Tax Section **www.abanet.org/tax** | 202.662.8670
April 3-4, 2008	**8TH ANNUAL TAX PLANNING STRATEGIES –** U.S. and Europe Conference – Madrid, Spain	Tax Section **www.abanet.org/tax** | 202.662.8670
April 10-11, 2008	**CORPORATE TAX U.S. AND EUROPE CONFERENCE** Hilton Embassy Row – Washington, DC	ALI-ABA **www.ali-aba.org** | 800.CLE.NEWS
June 5-6, 2008	**CHARITABLE GIVING TECHNIQUES** Langham Hotel – Boston, MA	ALI-ABA **www.ali-aba.org** | 800.CLE.NEWS
June 12-13, 2008	**HOW TO HANDLE A TAX CONTROVERSY AT THE IRS AND IN COURT** Renaissance Chicago Hotel – Chicago, IL	ALI-ABA **www.ali-aba.org** | 800.CLE.NEWS

Section Meeting Calendar | www.abanet.org/tax/calendar

DATE	PROGRAM	LOCATION
January 17-19, 2008 May 8-10, 2008 September 11-13, 2008	**MIDYEAR MEETING** **MAY MEETING** **JOINT FALL CLE MEETING**	Loews and The Ritz-Carlton | Lake Las Vegas, NV Grand Hyatt | Washington, DC Park Hyatt & Hyatt Regency | San Francisco, CA
January 8-10, 2009 May 7-9, 2009 September 24-26, 2009	**MIDYEAR MEETING** **MAY MEETING** **JOINT FALL CLE MEETING**	Sheraton | New Orleans, LA Grand Hyatt | Washington, DC Hyatt Regency | Chicago, IL
January 14-16, 2010 May 6-8, 2010 September 23-25, 2010	**MIDYEAR MEETING** **MAY MEETING** **JOINT FALL CLE MEETING**	Hyatt Regency | Denver, CO Grand Hyatt | Washington, DC Sheraton | Toronto, ON

At the Ballgame

By Gail L. Richmond*

The World Series is upon us, and this Tax Bites features taxpayers who had at-bats against the Service. In addition to a bit of baseball tax history, readers will discover a case in which the Section's current chair participated.

ACCUMULATED EARNINGS TAX

Charles O. Finley and Co., Inc. v. Commissioner, T.C. Memo. 1982-354 (Kansas City—soon to be Oakland—Athletics).

APPROPRIATE TAXABLE YEAR

Al-Hakim v. Commissioner, T.C. Memo. 1987-136 (amounts received by agent); *Tampa Bay Devil Rays, Ltd. v. Commissioner,* T.C. Memo. 2002-248 (advance ticket sales); *Artnell Co. v. Commissioner,* T.C. Memo. 1970-85 (prepaid income received before sale of White Sox); *Appeal of Boston American League Baseball Club,* 3 B.T.A. 149 (1925) (sale of Babe Ruth's contract to Yankees); *Baltimore Baseball Club, Inc. v. United States,* 202 Ct. Cl. 481 (1973) (sale of player contracts).

BACK PAY AND FICA

United States v. Cleveland Indians Baseball Co., 532 U.S. 200 (2001).

BASEBALL CARD SHOW INCOME

United States v. Strawberry, 892 F. Supp. 519 (S.D.N.Y. 1995).

BROADCAST RIGHTS

McCarthy v. United States, 807 F.2d 1306 (6th Cir. 1986) (Yankees).

INVASION OF PRIVACY

Meyer v. United States, 173 F. Supp. 920 (E.D. Tenn. 1959) (making of the movie Angels in the Outfield).

LOCATION OF TAX HOME

Dews v. Commissioner, T.C. Memo. 1987-353 (coach for Atlanta Braves); *Wills v. Commissioner,* 48 T.C. 308 (1967) (before the 1986 amendment to section 74(b), this case was probably better known for its treatment of the S. Rae Hickock belt awarded to Maury Wills); *Hornsby v. Commissioner,* 26 B.T.A. 591 (1932) (eligibility to split income with spouse).

LOAN OR STOCK REDEMPTION PAYMENT

Rogers v. United States, 281 F.3d 1108 (10th Cir. 2002) (Royals).

PLAYER CONTRACT ISSUES

Evinrude v. Commissioner, T.C. Memo. 1980-454 (Brewers; amortization); *Selig v. United States,* 740 F.2d 572 (7th Cir. 1984) (Brewers; valuation); *Kauffman v. United States,* 215 Ct. Cl. 925 (1977) (Royals; valuation).

SECTION 337 LIQUIDATION

Hollywood Baseball Association v. Commissioner, 42 T.C. 234 (1964) (for those who remember when the Giants and Dodgers left New York).

SIGNING BONUS—CORRECT TAXPAYER

Allen v. Commissioner, 50 T.C. 466 (1968); *Hundley v. Commissioner,* 48 T.C. 339 (1967).

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TAX BITES SUDOKU WINNER

In the last issue of the *NewsQuarterly,* Tax Bites challenged readers to come up with the phrase and solution to a Sudoku puzzle using strategically placed letters rather than numbers. The phrase was "tax policy" and the solution is below. Over 40 readers responded with the correct answers. Their names were entered into a drawing for a *Tax Lawyer* cap, and the winner of the cap is Michelle L. Heller, Muscatine, IA. Congratulations to Michelle and thank you to all who participated.

T	P	O	C	I	X	A	Y	L
L	X	C	Y	A	P	I	T	O
Y	I	A	T	L	O	P	C	X
P	Y	T	I	O	A	L	X	C
C	O	L	P	X	T	Y	I	A
I	A	X	L	Y	C	T	O	P
X	C	P	A	T	I	O	L	Y
O	T	Y	X	P	L	C	A	I
A	L	I	O	C	Y	X	P	T

State and Local Tax Committee

By Stephanie Lipinski Galland*

The State and Local Tax Committee (SALT) is an active part of the Tax Section, with almost 400 members. The SALT Committee focuses on the growing and challenging issues of state taxation for all 50 states and the District of Columbia. The Committee is made up of private practitioners, state tax department staff, corporate in-house counsel and tax department professionals, academics, and trade association members. The dynamics of this mix assure that many points of view are shared and that sessions at Section meetings are both practical and informative.

State and local taxation now generally represents more than 50% of the tax liability of a multistate business. In prior years, states conformed to the federal model to determine state tax liability. That is no longer the case. Faced with growing unfunded mandates and growing budget issues, states have reacted by deconforming and developing new and innovative positions on how businesses should be filing and paying state taxes. Examples of this trend include taxing *Geoffrey*/intellectual property companies and Delaware holding companies. Additional issues include state specific throwback rules, limitations on carry backs and carry forwards, forced combination, allocation versus apportionment and, of course, nexus.

The SALT Committee also is involved in following the federal legislation for Business Activity Tax, the Internet Tax Freedom Act, the State Sales Tax Simplification legislation and the Model State Tax Tribunal Act. Future projects include the possible NCCUSL UDITPA revisions.

In addition to the above, the Committee cosponsors the ABA-IPT Sales/Use, Property, and Income Tax Seminars in New Orleans every spring and the ABA-Georgetown State Tax Symposium in May in conjunction with the Georgetown State and Local Tax Institute. The Committee also publishes the *Sales & Use Tax and Property Tax Deskbooks*, as well as the annual *State and Local Tax Lawyer* and its companion *Symposium Edition* featuring papers presented at the Georgetown Symposium. The Committee is pleased to announce that beginning this year, future issues of the annual *State and Local Tax Lawyer* will be published as the *State and Local Tax Edition of The Tax Lawyer*, taking the place of the traditional summer issue of *TTL*. The Committee looks forward to working on *TTL's State and Local Tax Edition* and welcomes SALT article submissions from members.

The SALT Committee has the honor of having one of its newer members appointed to the Tax Section Nolan Fellows. The SALT Committee welcomes new members and the officers and members look forward to seeing you at the next meeting. ■

*Thompson Coburn LLP, Washington, DC.

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