

# FROM THE CHAIR

by Susan P. Serota\*



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## THE TAX GAP

**F**or much of the last year, the attention of Congress, the Treasury and the Internal Revenue Service has focused on an issue that continues to vex policy makers—the tax gap. What is the tax gap? In very basic terms, it is the difference between the amount of money taxpayers should pay and the amount that is actually collected when due. The tax gap, in principle, covers all taxes and all taxpayers. The tax gap is estimated to be over 300 billion dollars per year (based on 2001 data).

The Service identifies three types of compliance problems: (1) the non-filing gap—taxes not paid on time by taxpayers who file late or not at all; (2) those taxes not paid due to underreporting on timely-filed returns (e.g., understated income or overstated deductions or credits); and (3) those taxes reported as owed but not paid on time (some of which are recovered after the due date).

On September 26, 2006, the U.S. Treasury Office of Tax Policy released its Comprehensive Strategy

for Reducing the Tax Gap. Based on 2001 data, the compliance rate was over 86 percent, after including late payments and recoveries from IRS enforcement activities. However, the Treasury and the Service continue to be concerned that all taxpayers pay their fair share of taxes and understand their obligation to do so. “An unacceptably large amount of the tax that should be paid every year is not, requiring compliant taxpayers to make up the shortfall and giving rise to the ‘tax gap’.”

The Treasury has proposed a tax gap strategy based on four key principles: (1) unintentional taxpayer errors and intentional taxpayer evasion should both be addressed; (2) sources of noncompliance should be targeted with specificity; (3) enforcement activities should be combined with a commitment to taxpayer service; and (4) policy positions and compliance proposals should be sensitive to taxpayer rights and maintain an appropriate balance between enforcement activity and imposition of taxpayer burden.

The Section believes that it and other organizations, such as the AICPA, the American Tax Policy Institute and the American College of Tax Counsel, are uniquely positioned to assist tax policy makers in better understanding the issues surrounding the tax gap. To that end, the Section and these other organizations have determined to hold a national conference in June 2007 in Washington, DC, with a multidisciplinary approach to analysis of the tax gap that brings together academics and tax policy experts to explore the issues in depth. We will bring you more information on the conference as planning progresses.

## 409A

In August 2006, the Section requested that the Senate Finance Committee and the House Committee on Ways and Means review the impact and estimated cost of compliance of section 409A of the Code—the new rules on taxation of deferred compensation—before they become effective. Since that time, the Service has postponed the effective date of the final regulations to January 1, 2008. We hope that this additional year of “good faith compliance” provides Congress time to hold hearings on these new tax rules, which we specifically urged after the Senate passed an amendment to section 409A that would limit the amount of deferred compensation that can be deferred in any year. Although the Section has submitted many comments on the draft technical rules, we continue to believe that 409A is much too broad in scope, is intrusive on the employment relationship and affects too many middle management employees.

Section 409A was part of the American Jobs Creation Act of 2004, and addressed, among other things, executive compensation entitlements. Section 409A was meant to target abuses such as those uncovered during the Enron case, but instead its reach was much broader. It was not limited to top executives but was expanded to affect every employee and independent contractor—worldwide—who is subject to U.S. income tax on such amounts. It applies to any type of compensation which is earned in one year and paid in a later year, including severance arrangements and equity compensation programs. It was drafted so broadly that even the IRS and Treasury had to figure out a way to except collectively bargained severance arrangements.

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Because section 409A applies retroactively to all deferred compensation, unless vested as of December 31, 2004, it will require the review of every employment and independent contractor agreement, whether or not in writing, that is in effect on and after January 1, 2005, where a service recipient has agreed to pay compensation in a later year to a service provider in order to determine what parts of the payments, if any, are grandfathered, or are subject to the new rules; to uncouple the form and time of payment of Supplemental Retirement Plans from their corresponding qualified plans; and to provide new rules for when elections can be made as to the amount to be deferred, the form of the distribution and the timing of the distribution. The penalty for failure to meet these rules will more often than not fall on the wrong party—the individual who in most cases did not design the deferred compensation arrangement or when negotiating a severance arrangement (whether or not as part of a change in control) did not have a free hand in its design.

Interestingly, section 409A as enacted went farther than what was requested by Treasury during the legislative process. Treasury would have been satisfied if section 132 of the Revenue Act of 1978 had been repealed. That provision had legislatively tied their hands in developing new rules to control the aggressive positions many taxpayers and their employers were taking with respect to the design of deferred compensation arrangements. If the Congressional tax committees hold hearings, they might again request Treasury to put forth what it would need to assure the tax law's application to deferred compensation is not undermined.

Section leadership has identified section 409A as a priority for revision or possibly even repeal. We should use 2007 to focus the discussion on the scope of section 409A and work toward an agenda to fix it.

## PATENTING TAX STRATEGIES

At our Fall Plenary Session we learned that the Patent and Trademark Office is granting patents on tax strategies. These patents raise a number of issues both on a policy level and a practical one. It was noted that the granting of a patent by the government does not guarantee its legality; rather the test is whether the proposed strategy is novel, nonobvious and useful. One of the practical issues is whether the PTO examiners can properly identify “prior art”, i.e., tax strategies that are not unique or new, in order to determine whether a proposed strategy is patentable. The PTO has stated that it welcomes guidance on tax law from the Section, with the common goal of improving the process. In response, the Section's Patenting Tax Strategies Task Force has determined to help the PTO staff to identify such prior art by providing training in tax research in order to help them identify relevant information on commonly used tax strategies. The first of these sessions occurred in January where over 40 PTO examiners received training. These sessions were coordinated by Ellen Aprill and Mike Lang.

## MIDYEAR MEETING

The Section's Midyear Meeting in Hollywood, Florida featured many topical CLE programs, including the latest on FIN 48 rules, updates on exempt organization oversight, 409A issues, ethics compliance and many others. Many excellent government and private sector speakers took part in the panel discussions, and brought membership up-to-date on ever-changing tax regulations and policies.

Also at the Meeting, the Section hosted several pro bono opportunities for members. Volunteer Income Tax Assistance training was a valuable tool for members who learned how to provide tax preparation assistance and help in their local community VITA centers. A Low Income

Taxpayer Clinic workshop educated members and others about refund claim litigation and presented a mock trial at the end of the program.

Finally, join me in congratulating the six Nolan Fellows for 2007-2008 who were selected at the Midyear Meeting:

- Jennifer Alexander, Washington, DC
- Adam Cohen, Washington, DC
- Christopher D'Amico, Orlando, FL
- Thomas Greenaway, Boston, MA
- Pete Lowy, Houston, TX
- Brandee Tilman, Glendale, CA

All of the Fellows have made terrific contributions to the Section, and we look forward to their participation in future years as well.

## SECTION CLE PROGRAMS

The Section is always active in sponsoring stand alone CLE conferences and teleconferences. Between December 2006 and February 2007, we sponsored five teleconferences: (1) *FIN 48—Uncertain Accounting for Tax Uncertainties*; (2) *The New Tax Shelter Disclosure Rules: What You Need to Know Now*; (3) *Tax Practitioner Penalties—A Primer*; (4) *Can Patents Restrict Our Advice to Our Clients*; and (5) *Zero Basis—Alive or Dead*. In addition, we cosponsored two JCEB teleconferences—*Pension Protection Act of 2006 Part V: The Government Speaks and What to Do By Year End: Practical Applications of the Pension Protection Act*—as well as the annual ABA National Institute on Tax Criminal Fraud 2006 in San Francisco. Our CLE programs are some of the best offered, and we hope that you will take advantage of them each month. Please refer to the CLE Calendar in this issue or visit our website at [www.abanet.org/tax](http://www.abanet.org/tax) for information on upcoming CLE programs.

## SECTION PUBLICATIONS

To complement the Section's outstanding CLE, the Section also has a strong publications program to assist you in your practice. Recent titles include:

The Section's State and Local Taxes Committee annually produces two excellent deskbooks—*The Property Tax Deskbook* and *The Sales and Use Tax Deskbook*—which provide complete, state-by-state information and analysis on the laws, regulations, and practices in state and local sales/use and property taxation. In addition, the SALT Committee also produces an annual journal—*The State and Local Tax Lawyer*—which provides timely law

review articles and in-depth analysis on current topics.

*Guide to Nonprofit Corporate Governance in the Wake of Sarbanes-Oxley*—a collaborative effort between the Sections of Business Law, Health Law, and Taxation—is a handy guidebook written for directors of nonprofit organizations and practitioners and provides a complete overview of the major reforms enacted or triggered by the Sarbanes-Oxley Act, including governance reforms promulgated by the SEC and Stock Exchanges.

*Effectively Representing Your Client Before the "New" IRS: A Practical Manual for the Tax Practitioner with Sample Correspondence and Forms* is an

excellent resource for the general tax practitioner in handling all stages of representation before the IRS in controversy matters. *Tax Notes* called it "a worthy addition to any tax library because it is so effective in presenting extensive tax procedural information that is useful to both the journeyman and the master." The Section's Pro Bono Committee is collaborating with the Quinnipiac University School of Law on a comprehensive update of this three volume/CD-ROM set, which is expected to be available later this year.

These and other Section publications can be purchased by going to the website at [www.abanet.org/tax](http://www.abanet.org/tax) or by contacting the Section's office. ■

## 2007-2008 NOMINEES

In accordance with sections 6.1 and 6.3 of the Section of Taxation Bylaws, the following nominations have been submitted by the Nominating Committee for terms beginning at the conclusion of the 2007 Annual Meeting in August. Under the Section Bylaws, the current Chair-Elect, Stanley L. Blend of San Antonio, TX, will become Chair at the conclusion of the 2007 Annual Meeting.

<b>CHAIR-ELECT:</b>	William J. Wilkins, Washington, DC
<b>VICE CHAIRS:</b>	Ellen P. Aprill, Los Angeles, CA ( <i>Communications</i> ) Samuel L. Braunstein, Fairfield, CT ( <i>Professional Services</i> ) Elaine K. Church, Washington, DC ( <i>Committee Operations</i> ) Armando Gomez, Washington, DC ( <i>Government Relations</i> ) Louis A. Mezzullo, San Diego, CA ( <i>Publications</i> ) Rudolph R. Ramelli, New Orleans, LA ( <i>Administration</i> )
<b>SECRETARY:</b>	Alice G. Abreu, Philadelphia, PA
<b>ASSISTANT SECRETARY:</b>	Walter Burford, Washington, DC
<b>COUNCIL DIRECTORS:</b>	Christine L. Agnew, Houston, TX Peter H. Blessing, New York, NY C. Wells Hall III, Charlotte, NC Kathryn Keneally, New York, NY

In addition, under the bylaw amendment adopted by the Section at its 2007 Midyear Meeting, one additional member of Council will be added each year for three years until Council membership rises from twelve to fifteen. The Nominating Committee nominates John Barrie of Washington, DC, to become a member of Council upon approval of the bylaw amendment by the ABA Board of Governors and serve for a term ending at the end of the ABA Annual Meeting in August 2010. ■