Defending Liberty Pursuing Justice
Vol. 28 No. 4
SUMMER 2009
Section of Taxation
NEWSQUARTERLY

POINT & COUNTERPOINT

Equity, Cost of Living, and the Internal Revenue Code

Cost of living varies by geographic areas. In this Point/Counterpoint, Professors James Angelini and Tracy Noga argue that geographic cost of living adjustments have been ignored by the Internal Revenue Code and it is time to implement changes in the Code to reflect these differences. Professor Calvin Johnson argues that adjusting the tax base to take away the variations in cost of living would be inequitable while Professor Joseph Dodge argues that the geographic adjustments are not necessary. Professors Angelini and Noga respond that, because inequity exists, a remedy is necessary.

NewsQuarterly encourages readers to submit responses or comments which may be published in a subsequent issue. — *Christopher M. Pietruszkiewicz, Vice Chancellor for Business and Financial Affairs and J.Y. Sanders Professor of Law, LSU Law Center, Baton Rouge, LA*

POINT

Improving the Equity of the Federal Income Tax

By James P. Angelini and Tracy Noga*

One of the qualities of a good tax system, identified by Adam Smith and others, is the concept of equity or fairness. A tax system is considered horizontally equitable if it treats all taxpayers in the same economic situation in the same fashion. This is the basis of the federal income tax system in the United States and is often taken for granted. In our study we find, however, that due to considerable cost of living differences across the United States, horizontal equity (HE) is significantly distorted, not only between the states but even within states. James P. Angelini and Tracy J. Noga, *Distortions in Equity Caused by Cost-of-Living Differences*, 121 TAX NOTES 1165 (2008).

The purchasing power of a dollar is affected by time and space. Time differences are reflected in inflation adjustments to many (although not all) areas of federal income taxation. Periodic adjustments have been included in the Internal Revenue Code for many years. However, the Code virtually ignores geographic cost of living differences, except for a few minor adjustments. Although the cost of living varies considerably between geographic regions in the United States, the tax policies of a nation do not normally include major adjustments for the size, complexity and diversity of the economies of the cities and towns within its borders. As a result, HE is distorted. Furthermore, because changes in cost of living over time have not been made, the effects have compounded. A country as large and dynamic as the United States cannot expect to construct an income tax system that is horizontally equitable for all its citizens without taking into account the continually changing, and sometimes exponential, geographical differences in

continued on page 6

* James P. Angelini, Ph.D., CPA, Associate Professor of Accounting, Suffolk University, Sawyer Business School, Boston, MA; and Tracy Noga, Ph.D., CPA, Assistant Professor of Accountancy, Bentley University, Waltham, MA.

CONTENTS

Point & Counterpoint — Equity, Cost of Living, and the Internal Revenue Code 1
From the Chair — William J. Wilkins 3
From the Chair-Elect — Stuart M. Lewis 5
Interview — Mel Thomas 7
Points To Remember
When the Service Claims Compensation is Unreasonable 12
Is Your Exempt Organization Meeting the Rebuttable Presumption? 14
Qualified Intermediary Program Reform 16
News Briefs 18
Point & Counterpoint — CCA 200911007 and the $1 Million Mortgage Interest Deduction Ceiling 19
2009 Distinguished Service Award Recipient 28
CLE Calendar 29
Boxscore 30

TAXATION
A Section of the American Bar Association

NEWSQUARTERLY

ABA Section of Taxation

Summer 2009 Volume 28 Number 4
ISSN 1548–8977

EDITORIAL BOARD

COUNCIL DIRECTOR
Louis A. Mezzullo

SUPERVISING EDITOR
Gail L. Richmond

INTERVIEW EDITORS
Jasper L. Cummings, Jr.
Alan J.J. Swirski

SPECIAL FEATURES EDITOR
Christopher M. Pietruszkiewicz

PRODUCTION EDITOR
Anne B. Dunn

ASSOCIATE EDITORS
Nancy M. Beckner
Matthew S. Belcher
David A. Brennen
Steve R. Johnson
Leandra Lederman
Francine Lipman
Stephen Mazza
Glenn E. Mincey
David Pratt
Kathryn Morrison Sneade
Michael E. Steinsaltz

EDITORIAL POLICY

The ABA Section of Taxation NEWSQUARTERLY is published quarterly to provide information on developments pertaining to taxation, Section of Taxation news, and other information of professional interest to Section of Taxation members and other readers.

The NEWSQUARTERLY cannot be responsible for unsolicited manuscripts and reserves the right to accept or reject any manuscript and the right to condition acceptance upon revision of material to conform to its criteria.

Articles and reports reflect the views of the individuals or committees that prepared them and do not necessarily represent the position of the American Bar Association, the Section of Taxation, or the editors of the NEWSQUARTERLY. Although contributions are subject to selection and editing, the Section conducts no systematic review of these items. The Editors welcome new submissions as well as responses to material previously published in the NEWSQUARTERLY.

Manuscripts and letters should be mailed to: Assistant Staff Director, Publications, ABA Section of Taxation, 740 15th Street, NW, Washington, DC 20005.

Members of the Section of Taxation receive the NEWSQUARTERLY as a benefit of membership. Nonmembers are invited to subscribe to the NEWSQUARTERLY for $15 per year, or obtain back issues for $4 per copy. To order, contact the ABA Service Center, tel. 800/285-2221.

SECTION MEETING CALENDAR www.abanet.org/tax/calendar

DATE	MEETING	LOCATION
September 24-26, 2009	**JOINT FALL CLE MEETING**	Hyatt Regency – Chicago, IL
January 21-23, 2010	**MIDYEAR MEETING**	Grand Hyatt – San Antonio, TX
May 6-8, 2010	**MAY MEETING**	Grand Hyatt – Washington, DC
September 23-25, 2010	**JOINT FALL CLE MEETING**	Sheraton – Toronto, ON
January 20-22, 2011	**MIDYEAR MEETING**	Boca Raton Resort & Club – Boca Raton, FL
May 5-7, 2011	**MAY MEETING**	Grand Hyatt – Washington, DC
October 20-22, 2011	**JOINT FALL CLE MEETING**	Hyatt Regency – Denver, CO

IF YOU MISSED THE LAST SECTION MEETING

MATERIALS

As a benefit of membership, Tax Section members can view and search hundreds of papers and materials presented at the Section's Fall, Midyear, and May Meetings dating back to 1999 at: **http://www.abanet.org/tax/taxiq**. This service is made possible through Thomson Reuters Tax & Accounting and West, a Thomson Reuters business—a primary sponsor of the Section of Taxation.

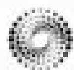
RECORDINGS

Audiotapes, CDs, and MP3s of programs from recent Section Meetings are available from Digital Conference Providers (DCP), the Section's audio service provider. Orders can be placed through the DCP website at **https://www.dcporder.com/abatx/** or by calling **630-963-8311**.

ONLINE CLE FROM WEST LEGAL ED

Many programs presented at the Tax Section's Fall, Midyear, and May Meetings are available as online CLE courses on the West LegalEd Center website. For more information, go to **http://westlegaledcenter.com**.

Thanks TO MAY MEETING SPONSORS



THOMSON REUTERS
TAX & ACCOUNTING

WEST
A Thomson Reuters business

A Primary Sponsor of the ABA Section of Taxation

SILVER

MILLER THOMSON LLP
Barristers & Solicitors
Patent & Trade-Mark Agents

BRONZE

Taggart & Hawkins, A Professional Corporation

William J. Wilkins*

For my final Chair's column, I'd like to look back on the Section's accomplishments and challenges in the past year. My overall impression of the Chair's job at this point brings to mind the image of a relay race, where each Chair needs to take a clean handoff, maintain and hopefully enhance the team's position, and then deliver a clean handoff from a position of strength. One reason this comes to mind is that so many of this year's accomplishments involved executing and finalizing great initiatives that were well under way when I started my term.

May Meeting

The May Meeting continues to deliver what our members want. Given the difficult economic times, we were apprehensive about attendance—but we need not have been. We had just over 2,000 attendees, which is in keeping with attendance of years past.

Our May Meeting would not be nearly as successful without participation of our government guests. More than 200 representatives from federal and state agencies, congressional offices, and the courts contributed essential insights for our substantive programming and CLE. We appreciate the contributions of time and attention that our government speakers have shown over the years, and I am grateful to committee chairs, panelists, and Section officers past and present who have helped make Section meetings welcoming and informative events for our government guests.

This year, we piloted a new format for our Friday programming at the May Meeting, in order to accommodate all Section committee meetings and CLE at the host hotel, the Grand Hyatt Washington. The new track of scheduling moved meeting times around a bit, and changed some of the committee lunch times. Attendees with whom I talked generally liked the changes. In particular, we were able to offer three more hours of CLE programming, and our shorter lunch break (made possible by using boxed lunches) made for a more efficient use of valuable Friday time. The active participation of Section committees in spotting and resolving issues with the many iterations of the proposed scheduling was the most important element in making the new schedule as successful as it was.

Leadership Changes

This year brought several changes to our Tax Section leadership. This spring our Chair-Elect, Karen Hawkins, resigned her Section post to become the new Director of the IRS Office of Professional Responsibility. Karen left the Section in mid-April, but joined us at the May Meeting Plenary Luncheon to accept the Section's thanks for her service, and to speak about her tenure as Chair-Elect.

In light of Karen's departure, the Section's Nominating Committee voted Stuart Lewis to become Chair-Elect upon Karen's departure. That vote was confirmed by the Section Council and ratified at the May Meeting Plenary Luncheon. Stuart is now Chair-Elect and will become Chair at the end of my term, which formally concludes with the ABA Annual Meeting in Chicago this August. Also at the August meeting, a new slate of leadership nominees will be considered and voted upon.

On May 12, President Obama nominated me to become Chief Counsel of the Internal Revenue Service and an Assistant General Counsel of the Department of Treasury. At this writing, I am awaiting the beginning of the Senate confirmation process. If I am sworn in before the formal end of my term as Section Chair, I will need to resign from my Section office but, as noted above, Stuart Lewis would immediately become Chair in that event. Stuart is already hard at work on Section leadership, and there are several active matters already receiving his skilled and thoughtful attention.

White Papers

An initiative of mine that I hope will be useful to future Section leaders is the drafting of "White Papers" on tax issues that are likely to come up for congressional consideration. In the past, the Section has occasionally been frustrated by the combination of a tight deadline for congressional testimony and the length of time needed to prepare appropriate testimony and have it approved by the Section Council and by ABA "Blanket Authority" processes. The White Papers are meant to provide background for testimony should the Section be asked to provide comment to the relevant committees and members of Congress. Several papers are already finalized and approved, and we expect that soon a total of five papers will have been approved and distributed to appropriate policymakers. The subjects are tax simplification; tax penalty reform; tax issues in health care reform; international tax reform; and transfer tax reform. These reflect significant contributions from some of our most active committees and best thinkers and writers, and will enable us to add our valuable expertise to ongoing policy debates.

Pro Bono Activities

Over the last year, the Section has stepped up our activities in the area of pro bono. We hired a staff attorney to help identify opportunities for our members

*Wilmer Cutler Pickering Hale and Dorr LLP, Washington, DC.

and to work with members and outside groups to develop programs that benefit low-income taxpayers.

Our investment in this area has paid off: we now have a Pro Bono Opportunities web page that provides information about low income taxpayer clinics that need assistance and allows members to sign up to help. The page also describes an important program to assist in the U.S. Tax Court on Calendar Call days, and encourages lawyers to get involved. The page is still being developed, and we are always soliciting ideas for getting our members involved. The web address is: http://www.abanet.org/tax/probono/.

Through the leadership of Ken Gideon and his special committee, we now have selected our first two Public Service Fellows, and we have excellent processes in place for future selection rounds.

Special Thanks

While it's not possible to thank individually everyone who helped me during my term as chair, I do want to take this opportunity to recognize the outstanding participation of our Council and Section leadership who contributed their time and many talents throughout the year. Karen Hawkins was an outstanding Chair-Elect, and took on several special tasks, including coordinating Section participation in this year's Tax Court Judicial Conference. Our Vice Chairs, Ruddy Ramelli (Administration), Peter Connors (Committee Operations), Ellen Aprill (Communications), Armando Gomez (Government Relations), Sam Braunstein (Professional Services), and Lou Mezzullo (Publications), along with Alice Abreu (Secretary) and Brian Trauman (Assistant Secretary), provided outstanding leadership throughout the year. Ruddy, Armando, Sam, Lou, and Alice will be moving out of their posts at the end of this year, so special thanks are due as they conclude their service.

I also want to thank our Delegates to the ABA House of Delegates, who have been of great assistance, Paul Sax and Dick Lipton. Their guidance and advice was invaluable during the many conversations with the ABA throughout the year. Section relations with ABA executives and governing bodies present challenges to every Section Chair. This past year was no exception, and this next year won't be either. We are fortunate to have Paul and Dick as our Delegates in these times.

As I first noted above, much of what a Section Chair accomplishes involves completion or continued good execution of well-designed initiatives of prior Chairs. I am grateful to my predecessors—especially Stanley Blend, Susan Serota, and Dennis Drapkin—not only for putting me in a strong position, but also for their ongoing hard work on the Section's most important management issues.

Our Council Directors and committee leaders have done a tremendous job this year in putting together outstanding CLE programming, organizing public policy comment projects, helping with the Section White Papers, and assisting with many other Section activities during the year. We are fortunate to have such an outstanding group of committed professionals who are willing to contribute their time and energy to the Section's work. Thank you.

I have to save my final and most heartfelt thanks of all for Christine Brunswick and her wonderful staff. Their dedication, good judgment, energy, organization, and good cheer keep the Section operating at the highest level, and make it a real pleasure to serve as a volunteer Section leader. ■

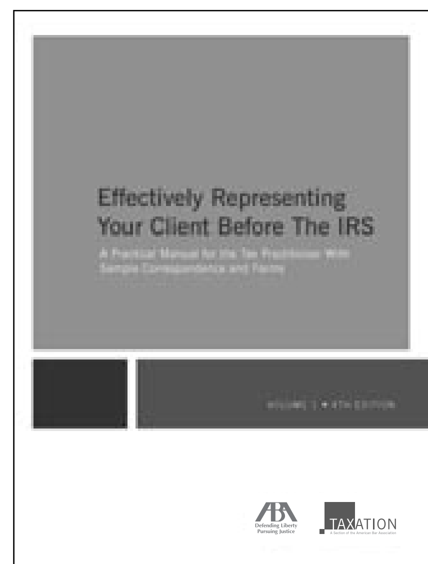
Effectively Representing Your Client Before the IRS

A Practical Manual for the Tax Practitioner with Sample Correspondence and Forms
4th Edition—2009

This two-volume reference includes 1500 pages of in-depth discussion of the law and hundreds of practice tips for all stages of representation before the IRS in controversy matters, including exam, appeals, Tax Court, refund actions, and collection matters. Also includes a CD-ROM filled with sample correspondence and forms.

$285 Regular Price
$225 Tax Section Member Price
$142.50 Nonprofit/Government/Academic (please call 800/285-2221 for this discount)

For more information and to place an order, contact the ABA Service Center at 800/285-2221 or visit www.ababooks.org.



Stuart M. Lewis*

We are indeed living in interesting times. We are now in the worst recession since the Great Depression. We have undertaken one of the most dramatic changes in our government in many years—one which may lead to major policy changes for our country. Many parts of the world continue to challenge us on a host of seemingly endless economic and security issues that will shape our policies and future, whether we like it or not. Living in interesting times may be a curse but it also provides an amazing opportunity to reconsider and reinvent many critical areas of our government.

While it will be my honor and privilege to assume the duties of Chair of the Section of Taxation, I am mindful of the many challenges that are confronting the Section over the near term. It will be my principal job to harness the tremendous resources of the members of the Section, with the help of Christine Brunswick and our fantastic staff, to ensure that we rise to the challenge and provide meaningful contributions on the issues within our expertise. I am confident that, given the experience and dedication of our membership, we will be able to take on these challenges successfully.

Recent courtesy calls to the Finance Committee, Ways and Means Committee, and Joint Committee on Taxation staff have made it abundantly clear that not only are we on the brink of major reforms in areas such as health care, energy and financial services, but that we are faced with an unprecedented and overwhelming need to raise revenue to finance the many initiatives being undertaken by President Obama and the new Congress. This pressing need for revenue can only be satisfied by increasing tax burdens. The job of the Section will be to help steer that tax imposition in a way that is well thought out, avoids undue complications, and maintains the efficiency that has been the cornerstone of our tax system.

Before delving into a few of the specific challenges that we need to address, I want to thank and commend the great leadership of my predecessor, Bill Wilkins, for his efforts over the last year. With tremendous foresight, Bill engaged the Section to prepare a series of white papers on issues ranging from health care to foreign tax that have positioned the Section to provide further input on these critical issues. We are now able to be as responsive as we can to developments in these areas.

Membership Challenges

The Section has been fortunate so far. We have maintained a total membership at 22,000+, avoiding any major decline. The warning signs, however, are all around us. The ABA has instituted an Association-wide hiring freeze that directly impacts the Section and it anticipates a substantial decline in membership renewals. The cutbacks at law firms and the accompanying cost-cutting that many law firms are currently undergoing cannot mean good news for the Section.

Membership issues provide a multi-faceted series of challenges. In addition to the need to maintain and increase our membership levels, we simultaneously need to continue to broaden our membership in many ways. These are ongoing efforts that the Section has been working on for many years and will continue to be a top priority. Diversity of membership is clearly one of our most important goals and one which, like many other aspects of the Section, is best accomplished at the committee level. By identifying and engaging members with diverse racial and ethnic backgrounds we will all benefit.

We also need youth. The Section has demonstrated a steady aging trend. While I increasingly recognize the wisdom that comes with age and experience, it is also apparent to me that the Section needs the infusion of younger members and their active involvement in Section matters. Over the years, the Section (with the great help of the YLF) has made great improvements in involving younger members through activities such as the first-time attendees dinners at Section Meetings and the Law Student Tax Challenge. This needs to be an unceasing effort that will only be more difficult in the current economic climate.

Like many other challenges facing the Section, the key is member involvement, innovation, and a continued focus on these issues.

Economic Challenges

The current recession and the decline in the stock markets presents economic difficulties with which the Section will have to cope. Our revenues come from many sources in addition to membership dues. All of these sources are likely to be under constraints in the near term. Our Vice-Chair, Administration, Ruddy Ramelli, has done a fantastic job of keeping our finances in good shape. I look forward to working with Fred Witt, who will be taking over from Ruddy, to maintain a strong economic foundation for the Section.

The Section's mission, however, includes providing first quality services to its members. We have no intention of cutting back on either the quality or quantity of the CLE meetings, pro bono activities, or any of the other essential services of the Section. This will provide some serious challenges as we go forward.

*Buchanan Ingersoll & Rooney PC, Washington, DC.

Legislative Challenges

President Obama, in his recent explanation of his revenue proposals for fiscal year 2010 (the so-called "Green Book") has laid out an ambitious agenda for changes to the Internal Revenue Code. Other changes in addition to those in the Green Book are brewing in Congress. Changes to estate and gift taxation, to foreign taxation, to executive compensation, and to health care are just a few of the many topics likely to be visited this year or next.

We will continue to be vigilant in our efforts to provide input to the Congress and the Administration on improvements and problems with our tax system. Simplification of the Internal Revenue Code remains one of our highest priorities. Unfortunately, we may be the only organization that makes a continual and concerted effort to improve tax simplification, which puts an even greater burden on us to continue to carry that torch.

Armando Gomez has provided outstanding service in representing the Section as Vice Chair, Government Relations, before Congress and the Administration. His valuable contributions to the efforts of the Section have made it certain that we were heard—even if we were not always listened to. I am sure that Armando's successor, Helen Hubbard, will deliver the Section's messages equally as well.

The Challenges of Keeping Up the Good Work

The activities of the Section are diverse and essential to maintaining the vitality of the tax community. By being involved in almost every aspect of tax law, from providing pro bono assistance to shaping the nation's tax system, the Section maintains its critical role as the leading organization on tax matters.

Maintaining this operation is not easy. We have roughly 50 committees, the largest of which has as many as 50 subcommittees, that undertake numerous activities, not the least of which is providing valuable and insightful comments to government regulators. Individuals at the IRS repeatedly tell me how important the comments of the Section are to them as they develop regulatory guidance. We all owe a debt of gratitude to Peter Connors, our Vice Chair, Committee Operations (VCCO), who keeps this machine operating efficiently. VCCO is not always the most well-recognized or popular position, but it is essential to the effective operations of the Section.

We also need to continue to maintain our public face. For this we owe our thanks to Ellen Aprill, our Vice Chair, Communications, and to Lou Mezzullo, our Vice Chair, Publications, for making the public aware of our activities and providing valuable technical publications. I look forward to working with Doug Mancino, who will be taking over our publications from Lou.

CLE is one of the most important activities of the Section and one that is highly valued by our members. Sam Braunstein, our Vice Chair, Professional Services, has done a magnificent job of not only maintaining, but elevating the quality and quantity of our CLE activities. I look forward to working with Emily Parker who will be taking over for Sam in leading our CLE efforts.

All of these efforts come together to make the Section the incredible organization that it is today. This success can only be continued with the renewed dedication of our members in these difficult times.

I look forward to working with each of you over the next year and would be pleased at any time to receive suggestions you may have regarding the issues outlined here or any other matters that the Section should address. I look forward to seeing everyone at our next meeting in September, which is a joint meeting with RPTE in Chicago. ■

COST OF LIVING ADJUSTMENTS | **POINT & COUNTERPOINT** *continued from page 1*

cost of living. We recommend several policy changes to help eliminate the inequities created by cost of living differences.

It is well known that geographic cost of living differences vary considerably by state, and within states by city and town. A person living in a high cost state, such as New York, will pay a significantly different federal income tax than someone living in a low cost state, such as Alabama, even though both taxpayers have the same income. This is due to several factors. Taxpayers in high cost states pay higher expenses that may be deductible, such as state and local income and property taxes, housing costs (mortgage interest), automobile expenses, travel and entertainment expenses, and other items. Therefore, taxpayers in high cost states may pay less in tax than their counterparts in low cost states.

In some cases, however, taxpayers in high cost states with larger deductions may pay higher federal income taxes than taxpayers in a low cost state because of the Alternative Minimum Tax, which disallows deductions for state and local income and property taxes and miscellaneous itemized deductions. Other examples of geographic inequity include the automobile mileage allowance and the parking fringe benefit exclusion, which is the same regardless of where you live. These amounts do not take into account wide geographical variances in auto insurance, gasoline, parking fees, average commuting distances, etc. Furthermore, in comparing high income states to low income states, adjusted gross income (AGI) will vary considerably among the states and itemized deductions and credits are affected because of phase-out rules and

continued on page 11

Mel Thomas

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

Mel Thomas has recently retired from the staff of the Joint Committee on Taxation, which he joined in 1976.

Q How did you come to work at the Joint Committee?

A When I got out of high school, I knew I was going to be a tax lawyer. I majored in accounting in college, and I went to a law school that offered a lot of tax courses, Northwestern. While at Northwestern, I was the research assistant to one of the two tax professors there. The other tax professor at Northwestern, Vance Kirby, who was Tax Legislative Council at Treasury during the writing of the '54 Code, had retained a relationship with the Chief Counsel's office under which he would send a couple of the best people from Northwestern to the Chief Counsel's Office in D.C. each year. As a result of his recommendation, I went to work in the L&R division of the Chief Counsel's Office. In that job, I helped draft some legislation, but primarily wrote regulations for four years. My major regulations project was writing the regulations on charitable remainder trusts under section 664. In addition, I wrote the initial drafts of regulations on reserves for bad debts of banks under section 585 and on split-interest charitable transfers under sections 2055(e)(2) and 2522(c)(2).

At the end of my four-year commitment to the Chief Counsel's Office, Johnnie Walters, who was leaving his job as IRS Commissioner, asked me to go to work with him at Hunton & Williams. The day after I had accepted the job working with Walters I received a call from Bob Shapiro from the Joint Committee inviting me to join the JCT staff. I responded that I just accepted a job with Walters, but I would like such an opportunity if the job with Walters did not work out. When I accepted the job with Walters, I had assumed that there would be a lot of tax work to do since Walters had been both Assistant Attorney General of the Tax Division of Justice Department as well as IRS Commissioner. Nonetheless, later I learned that Mr. Walters had been linked to President Nixon's "enemies list" and when that relationship became public our tax business dried up and, as a result, I called to see if the position on the JCT staff was still available. It was and I joined the JCT on April 1, 1976.

Q At that time Larry Woodworth was the Chief of Staff. Tell us about him.

A Larry was sort of an amazing guy in terms of intellect and political acumen. He was both patient and persistent; he had a sixth sense of what tax legislation was necessary and politically possible. In addition, he had earned after years of service the trust of both Russell Long and Wilbur Mills, so much so that they sort of trusted him in putting together tax legislation. So when you worked for the Joint Committee staff under his tutelage you had the power and responsibility to make most of the decisions in drafting. You were the decider of policy at that point in time. And that power lasted up until the middle of the 1990's. The Joint Committee staff were the people who made the numerous policy decisions in putting a provision together. Of course, that power was not so broad such that you could decide whether or not a provision was going to be in the bill but, again, most of the decisions that implemented those decisions were made by the Joint Committee staff.

Larry was trained as an economist. That helped him a great deal in the long run because he took a longer view of tax legislation than subsequent Chiefs of Staff who were lawyers in terms of where the tax law can and should go. Larry also always realized that any decision he made had to run through a political filter; he realized that he wouldn't urge a provision that would cause problems for either Mr. Mills or Russell Long. These two features really made him special.

Q Most of the other Chiefs of Staff with whom you worked were lawyers. Did that make a difference in the way the office is run?

A After Larry, the Chiefs of Staff who were lawyers were not as adept with political sensitivities as Larry had been. The closest to Larry's style were Bob Shapiro and Mark McConaghy, who were the next Chiefs of Staff after Larry had moved on. But after that, the subsequent chiefs were less sensitive to political realities, probably because they had not been exposed to the tax legislative process as long as Larry.

In addition, maybe Larry, as an economist, had been less burdened with a lawyer's typical approach of seeing lots of problems in legislation and trying to steer things away from them. Larry wrote some classic legislation that stood the test of time better than a lot of the more recently passed legislation.

Q What was the relationship between the L&R Division of Chief Counsel and the Staff at the Joint Committee?

A In order to answer this question, it would be helpful to describe the drafting process when I joined the JCT staff and how it has changed over the years. Drafting on the House side was and still is done in a room in the ground floor of the Cannon House Office Building. The room in which drafting occurred was a long narrow room with two green "black" boards on its left side. There was a long narrow table in the room and

* Jasper L. Cummings, Jr., Alston & Bird LLP, Washington, DC, and Raleigh, NC, and Alan J.J. Swirski, Skadden Arps Slate Meagher & Flom LLP, Washington, DC.

there were, in substance, assigned seats around the table. Drafting of tax legislation was done principally by the House Legislative Counsel, Ward Hussey. Mr. Hussey and his assistants sat in the first three seats on the left side of the table. Next in order of seating was the most JCT staff person, then other JCT staff, then persons from Treasury's Tax Legislative Counsel's office, then representatives from L&R, and finally IRS representatives.

At a drafting session, a description of the problem the proposed provision was to address was provided by the most senior JCT staff person at the drafting session. That person and others from the JCT staff sat in the seats immediately adjacent on Mr. Hussey's left side. Comments were made to the senior JCT staff, who passed them on to Mr. Hussey; comments were not to the room as a whole. This description often was supplemented by persons from Treasury's Tax Legislative Counsel, especially when drafting involved a proposal that came from the Administration. Mr. Hussey would listen to this description, occasionally asking a question.

Examples of the provision frequently were put on the black board in order to illustrate how the provision was expected to operate. After some undefined amount of time, Mr. Hussey would simply leave the room for 15 minutes or so. A short period of time after Mr. Hussey returned to the room, his secretary would return with copies of the proposed statute, complete with technical and conforming amendments, that Mr. Hussey had dictated while he was out of the room. After copies were distributed, there were a few moments to read the proposed draft followed by comments by persons from the various staffs in the room. Occasionally, Mr. Hussey would leave the room to dictate a new draft. When the comments would require modifications that could not be easily incorporated in the draft, there was a direction that this issue should be covered in the committee report, with the understanding that this issue subsequently also would be included in any income tax regulations that would be issued by the Treasury Department. Thus, representatives from L&R were included in the tax legislative process. In addition, originally L&R drafted original versions of statutes, committee reports and that sort of thing of Administration tax proposals.

When Mr. Hussey retired after the '86 Act and word processors replaced secretaries taking dictation, drafting radically changed. Now drafting on the House side involves primarily Ways and Mean's Chief Tax Counsel, John Buckley, others from his staff, normally, but not always, JCT staff and occasionally representatives from the Treasury; more often than not, nobody from the IRS. Drafting sessions involve Ways and Means staff setting forth what they want. These sessions are much shorter than before; examples are rarely put on the black board. Drafts typically are distributed as an attachment to an Email; there typically is no meeting to discuss comments on the draft. The finer points of a proposal are just not raised.

Before Larry expanded the legal staff of the Committee in the 70's, there were only a few lawyers on the staff. But when you look back at the legislation of the 1960's you see that they were relatively small bills compared to more recent legislation. There were a lot of things that needed to be done and Larry started building up his staff until he had 20 or so lawyers. This ultimately led to or coincided with the demise of the L&R division. Once the Joint Committee Staff had bulked up, it was unnecessary for L&R to do any drafting of legislation; L&R became unnecessary. In fact, I think the last Act that the L&R Division had a significant participation in was ERISA in 1974. Once L&R was unnecessary for drafting legislation their presence in the drafting sessions was helpful to them only because they would have to write regulations on the same legislation, so it helped to know how the legislation was put together.

Q Would you say that in hindsight the loss of L&R has had a sort of profound effect in removing line attorneys at the IRS from drafting?

A Yes. The L&R Division had about 40 lawyers. After the legislation drafting work dried up, basically their sole function was writing regulations. After L&R was disbanded, you did not have that critical mass of lawyers in Chief Counsel writing regulations on a regular basis. The effect on the regulations process has to me been the most profound thing of the loss of L&R.

There are many cases in writing statutes when you make specific delegations of regulatory power where you do not have time to draft necessary or appropriate language in the statute. There have been numerous cases where Congress has delegated power to write regulations that either have never been issued, or took a very long time to be issued. A couple of cases that come to mind are section 7872 and section 67(e). Due the lack of regulations under section 67(e) the Supreme Court recently had to weigh in. So, to me, the biggest downfall from the loss of L&R was the loss of the regulations drafting function.

Q As you know, the lawyers in L&R were pulled into Chief Counsel and dispersed to the corporate and pass-through divisions and now assist with regulations, but do you think there was better focus on regulations when the 40 lawyers were working on them?

A Being an alumnus of L&R, I think the answer is yes. I think that because you were spending your full time thinking about regs you were better prepared to draft them. In addition, you still had a companion helping you from the technical division so that you were not doing things inconsistent with what they were doing on the technical side. Lastly, someone from Treasury was part of the regulations writing team to make sure you were not writing regulations beyond the scope of the appropriate Tax Policy.

I do not think that the present regulations writing process has the same level of coordination as when L&R existed, or the same level of making sure that there are regulations that cover all the things for which regulations should be written.

Q The Joint Committee has both revenue estimating functions and legal drafting functions, as well as the job of reviewing large refund claims. Have you seen the balance of these functions shift over time and how?

A Yes. When I came to the Committee, aside from the lawyers there were only two or three revenue estimators. Their methodology was more a general familiarity of where and how the government raised money and how things were done. Their work was then more of a judgment sort of thing. That has evolved now that the Joint Committee estimates have become the official estimates of tax legislation to where the estimating team is much larger and their estimating methodology is very sophisticated. Revenue estimating today is based on models built to represent the various areas of the economy to take into account size of that area in the economy, and how those economic functions are taxed under present law. And then when the legislation is proposed to modify these rules, the models can determine how the change would affect revenues; this is a much more sophisticated way of estimating.

As to reviewing refund claims, the size of the refund staff has stayed basically the same over the years because the threshold for cases that are referred to Joint Committee has been significantly increased over time. There are now and have been three or four refund lawyers. That number is basically all they need and generally they have been able to handle the refund function pretty much by themselves. Earlier in my tenure on the staff, there were many times when the legislative lawyers were brought in for counseling on significant refund cases. This happens now a lot less frequently.

As to the legislative function of lawyers on the JCT, what the lawyers do has changed tremendously. As I said before, when Larry Woodworth was Chief, he had built up a relationship with Russell Long and Wilbur Mills that allowed the lawyers to be the deciders of policy. As a result, to my mind the work of the staff was a lot more challenging; some one gave you a project and your job was to make this thing work. With the demise of that relationship over time, you basically are writing up other people's decisions as opposed to making decisions yourself.

In addition, when Larry was Chief of Staff, he viewed the committee report written by the staff as the principal legislative document of Congress. His view was that the statute was only an outline of the committee report. That has been radically changed now to where the committee reports are more sort of Reader's Digest versions of the statute. That is, while the statute generally is written as a complete sentence, the sentence contains a lot of clauses and the committee report takes each of the clauses and turns it into a separate sentence. The predicate of that sentence is often the language of the clause, many times taken almost verbatim from the statute The committee report is easier to read than the statute, but imports no new knowledge or rules. The older committee reports often contained a lot more of the rules necessary for the functioning of the statute.

Q Did an increase in the size and influence of the House and Senate Committee staffs play into that shifting?

A I do not know whether it was a cause or the effect. I think the shift in functions was due to both a change in the leadership from Democratic to Republican and the fact that the Chief of Staff of the Joint Committee has changed lot more rapidly in recent years. Of the 15 Chiefs of Staff of the Joint Committee on Taxation, I worked there for 33 years and worked for 13 of those 15 Chiefs of Staff. This amount of change is fast when one considers that the first two Chiefs of Staff lasted for 40 years. Now the Chiefs of Staff turn over a great deal—two or three years before generally they move on. Because of that turnover level I do not think a Chief has been able to build up that level of trust that Larry had been built up with Long and Mills. So the House Ways and Means and Senate Finance Committee chairmen may feel less willing to safely delegate things to the Joint Committee. They wanted their own personal staff to perform those functions. I believe that is what happened, and that is why the nature of what the lawyers of the Joint Committee staff do has drastically changed.

Q You did a lot of work on depreciation rules. Do you have any stories?

A As I've already said, I was an accounting major during my undergraduate days. While there I did my honors paper on the relationship of generally accepted accounting principles to tax accounting principles. One of the chapters of that paper dealt with depreciation. As I learned from my research for that paper, if you go back to the turn of the 20th century the accounting world did not have depreciation at first. Instead, accounting dealt with capital costs under the so-called RRB method—repair, replacement or betterment, all of which were expensed. In the 1930's, President Roosevelt needed money and he asked his Secretary of the Treasury how he could raise taxes if he could not do it directly. Secretary Morgenthau told him he knew how to do it indirectly; he unilaterally would have moved everyone off the RRB method to straight line depreciation accounting on the grounds that depreciation resulted in a clearer measurement of income. Depreciation drastically reduced business deductions compared to the RRB method. And that is what paid for the build up of Armed Forces without having to raise any taxes in the time of the Depression; all that was done by administrative fiat.

Q Did you specialize in certain issues?

A I did work in all of the areas in which I had some background. This got me doing work in all areas other than pensions and foreign. For example, I worked on all the legislation in the accounting area since accounting was my major in my undergraduate days. This included working on all of the time value of money rules in the '84 Act. I got involved in the taxation of estates and trusts under subchapter J, estate and gift taxation under chapters 11 and 12, taxation of charities and charitable transfers as a result of my writing the regulations on charitable remainder trusts and those for split gifts. I worked on taxation of banks and other financial institutions as a consequence of writing the section 585 regulations while in L&R. I also did a lot of work in pass-throughs such as regulated investment companies and real estate investment trusts while at L&R and so continued in that area while at the JCT. This later included the provisions of the '86 Act on REMICs. I worked on the taxation of cooperatives as a result of an article I worked on in that area as the research assistant of my tax prof. at Northwestern. I worked on legislation relating to tax-exempt debt as a result of several rulings I worked on while at Hunton & Williams. Ironically, I was assigned work on bankruptcy taxation since bankruptcy estates were originally taxed in the same manner as decedent's estates and trusts. There were many other areas in which I worked over the past 33 years; too many to mention here.

Q Tell us about the adoption of section 338.

A The story began when Treasury initially did not like 338. Indeed, Treasury was about to walk away from a meeting on the subject when I told a joke to get them to stay. After everyone laughed at the joke, things calmed down and we worked through the 338 rules.

That reminds me of the savings and loan bailout legislation in 1981. Section 597 was the most difficult thing that I saw in that regard policy wise because it looked like allowing the sale of losses as part of a restructuring of bankrupt savings and loans and almost cost me my job. Well, the idea of the tax law allowing the sale of losses is antithetical to most rules like sections 382 and 265. All of a sudden section 597 comes along as a Senate floor amendment and arguably could be read to allow the sale of losses arising from restructuring of loans of a savings and loan association in bankruptcy. During the conference on the '81 Act, I tried to learn its purpose so that it could be clarified to be consistent with its purpose. My efforts were stopped short when the amendment's sponsor phoned me to say that my efforts to clarify his provision "would not be appreciated." As a result, the purpose of the provision remained unclear for a period of time; eventually though the agency that dealt with the restructuring of savings and loans started organizing sales premised upon the sale of losses. The uncertainty was removed when Treasury announced its interpretation of the statute not allowing the sale of losses—a decision that many felt was a change in interpretation since many losses were thought to be purchased by nonbankrupt savings and loans who said they bought those losses in good faith and now had them being taken away from them.

Q As you know, that has some analogy in recent times to a notice that the Treasury put out last year saying that banks did not have to treat loan losses as built in losses for purposes of section 382 changes of ownership.

A Yes. As you know, that notice was repealed by recent legislation and I was involved in estimating the revenue consequences of that legislation. The interesting question in making that estimate was determining the base line, because there is another rule under section 382 saying that any bad debts written off more than one year after the change of ownership would not be limited. So then you get into the question of whether or not you could effectively avoid the limitation of section 382 through not claiming a bad debt deduction until after the one-year period ending after an ownership change.

Q Do you feel that the Joint Committee is sort of isolated, or did you see a lot of "lobbying" on tax issues from outside, and how does that work?

A Well, first of all, there was a change in that regard. Initially, as I said, the Joint Committee staff made all of the policy calls. Because of that, every lobbyist who was proposing a change in the tax laws scheduled meetings with the JCT staff so that they could tell us what they had been trying to do. Such information would be helpful to us, so that we could help a member who wanted that proposal adopted.

Now that the Joint Committee does not make those policy calls, those meetings do not occur as often and therefore the nature of the process has changed.

Q How does the actual "joint committee" make-up of the senators and congressmen work in connection with Committee staff?

A The Joint Committee in terms of the Congressmen does not really function as a separate committee apart from the Senate and House Committees. Nonetheless, all of the members of the Joint Committee were also the most senior members of the Ways and Means Committee and the Finance Committee. As such, they have an interest in the tax legislation, but I have never seen where they have used their office as a Joint Committee member to get a leg up on other members in terms of legislation, other than being the most senior members of the Ways and Means and Finance Committees and, consequently, having some higher priority merely because they have such seniority. Other than that, I think basically the function

of the Joint Committee is to make sure that there are sufficient staff to perform the functions that they needed.

Q Did you work on hedge accounting?

A Normally most of the things you get to work on in the Joint Committee is legislation suggested by the administration. There was one project that I worked on where what happened was exactly the other way—a solution to a problem was considered by Congress but was adopted administratively by Treasury. This was the *Arkansas Best* issue. If you recall, *Arkansas Best* was a case that arguably overturned the *Corn Products* doctrine as to what assets would be treated as ordinary even though they did not literally come within the exclusions of what is a capital asset under section 1221. Well the uncertainty caused by that case became a huge issue because it effectively left a lot of people in a no man's land of uncertainty. Efforts to solve that uncertainty legislatively had stalled since, depending upon how you scored the effects of the *Arkansas Best* decision, legislation was going to either raise or cost a lot of money, with the result that it was impossible to move on the thing. I had been attending a study group sponsored by Virginia Tech where the subject of hedge accounting was discussed. In the case of hedge accounting, the two elements of hedge are paired together and not taken into account until the hedge was terminated. The idea of applying that concept to solve the *Arkansas Best* problem sounded like a good idea if a set of rules could be adopted that provided certainty, but could not be abused. Accordingly, I put together a group of people on our staff and Treasury and IRS to work on such a proposal. We worked over a year making sure that it worked and did not create either character or time mismatches. Unfortunately, our work did not solve the revenue problem.

In the meanwhile, the *Fannie Mae* case was decided and allowed ordinary treatment of some assets that did not literally come within the exclusions of section 1221, which meant that the Treasury was able to issue regulations under sections 1221 and 446 that basically adopted the Hill-originated proposal administratively since Congress was unable to adopt it legislatively. ■

POINT & COUNTERPOINT | COST OF LIVING ADJUSTMENTS *continued from page 6*

percentage limitations, which cause a taxpayer to lose deductions or credits as income rises.

One of the fundamental characteristics of a fair tax, ability to pay (as measured by income), however, is not adjusted automatically for cost of living differences between geographic areas. Cost of living research indicates that there is no immediate theoretical correlation between the cost of living in a particular area and the wages paid in that area, except in the long term due to assumed migration, as the demand and supply functions are separate for these items. The cost of living is determined by the demand and supply of housing, food, etc., and wages are determined by the demand and supply of labor for a particular job.

For example, New York City has a high cost of living but that does not mean that if you are an engineer and you move there you should expect higher pay. Your pay is determined by the supply of engineers and the number of job openings for engineers. One may argue that theoretically, in the long term, these inequities should equalize due to migration of workers or businesses. However, we certainly cannot assume that there is no need to adjust tax laws to improve horizontal equity for cost of living differences because the other side of the equation, income, will automatically compensate, even in the long term. Workers and businesses migrate for various reasons, not all of which are economic or related to labor costs. Clearly, federal law taxes geographical differences on the income side of this equation. It should also make adjustments for differences on the expense side in order to improve equity.

As stated earlier, horizontal equity is defined as treating taxpayers in the same economic situation in the same fashion. Simply stated, with respect to the income tax, individuals in the same economic scenario should pay the same amount of federal tax. It is important to note that equity measures do not specifically measure the level (amount) of the tax liability. The equity measure simply determines if taxpayers in the same economic situation pay the same amount of tax; it does not determine if that amount is too high or too low relative to that of other groups.

In our study, we calculate HE for married filing joint individual tax return data for 2001. Our results show, on the federal level, an increase in income results in decreased HE. This seems counterintuitive because, as income rises, tax deductions and credits phase out and taxpayers are on more equal footing. However, looking at the detail for each state, HE does not systematically decrease with an increase in income. The interaction effect of owning vs. renting and dependent children vs. no dependent children further complicates the analysis, and is exacerbated (or perhaps explained) by the difference in HE between states and within states due to great variances in housing costs, property taxes, state and local income taxes, and tax credits and exemptions for dependent children. The analysis shows that there is a considerable difference between the tax burdens of individuals across the United States who are deemed to be in the same economic situation or who are deemed to have the same ability to pay.

continued on page 23

POINTS TO REMEMBER

When the Service Claims Compensation Is Unreasonable

By Robert W. Wood*

What is reasonable compensation? It may sound like an oxymoron, particularly when AIG and other bailed-out companies reward executives with outsize bonuses. With the public outcry over pay, it's an opportune time to ask how much compensation is reasonable, and why we care.

The reasonable compensation doctrine is a sticky tax concept. You want compensation to be "reasonable" to avoid double tax, so the company paying the compensation can deduct it. Although these days most of the criticism is being leveled at public companies, the tax issue is almost exclusively a problem with closely held companies. The company can deduct "reasonable" compensation, but not unreasonable compensation or dividends.

Often taxpayers end up in a defensive posture, trying to show they were really worth the money so their closely held company can deduct it. Yet a recent appellate decision put the Service, and perhaps even the Tax Court, on the defensive on this issue. The case is *Menard, Inc. v. Commissioner*, 560 F.3d 620 (7th Cir. 2009), and it represents a big taxpayer victory.

The Compensation Contract

Menards is the country's third largest home improvement chain, trailing only Home Depot and Lowe's. In 1998, Menards had 160 stores in nine states, reporting revenue of $3.42 billion, and taxable income of $315 million. John Menard, its founder, controlling shareholder, and CEO, had a base salary of only $157,500.

Since 1973, the Menards patriarch has received an annual bonus equal to five percent of the corporation's net income before taxes. The compensation contract included a savings clause, requiring him to repay any portion of his compensation for which the Service disallows a deduction. This savings clause, it turns out, was pretty important, at least for 1998.

1998 was a very good year for the company, and yielded a $17.5 million bonus for the founder. When added to his salary and profit-sharing, his total compensation exceeded $20 million. The Service said this was so far beyond reasonable that it was unfair to allow the company to deduct it. In 2004, the Tax Court agreed, concluding that only about $7 million was "reasonable." The court treated the remainder as a non-deductible dividend. In 2005, the Tax Court reconsidered its determination, but upheld it.

Give Me Shelter

The corporation appealed to the Seventh Circuit. Notwithstanding the limited standard of appellate review, that court ruled that the Tax Court had committed clear error in finding this compensation to be excessive. Judge Posner's opinion skewered two aspects of the Tax Court decision: its savings clause analysis, and its formula for determining that $7.1 million was "reasonable."

There is also a nice reference to the Tax Court's strange comment that Mr. Menard needed no incentives to work hard, since his majority ownership yielded all the incentives he needed. That theory, said the Seventh Circuit, meant the Tax Court was internally inconsistent by ruling that $7.1 million in compensation was reasonable. Strange logic, quipped Judge Posner. Each of these areas of contention yields benefits for those who walk in Mr. Menard's steel-toed shoes.

Savings Clause

I've long been a fan of provisions in agreements that recognize the importance of taxes. One sees such provisions in acquisition agreements, in settlement agreements resolving litigation, and in compensation agreements. Whoever first thought of a provision in a compensation agreement requiring the recipient to return any pay that was later ruled to be non-deductible, it is a good idea, at least from a tax efficiency perspective.

Yet, does such a provision undercut the substance of the tax argument, making it less likely the payment will be deductible? That's a concern often raised about savings clauses. The parties have said in advance that *if* there is a tax problem, they have allocated the burden of that tax problem. Most business people would not think that constitutes an admission that there *is* a tax problem, though some will argue it helps to flag the issue.

Still, it is worth considering this canard, for the Service and the Tax Court in *Menard* both thought it significant that the compensation agreement included such a provision. The Service and the Tax Court felt such a clause made the payment look more like a dividend, as did a formulaic percentage of corporate earnings bonus. The Seventh Circuit called such arguments "flimsy."

To the sometimes metaphysical question of what *looks* like a dividend, the Seventh Circuit said that dividends are generally specified dollar amounts, not a percentage of earnings. Paying a fixed dividend gives shareholders more predictable cash flow than a dividend that varies with fluctuating corporate earnings. The formula for Mr. Menard's bonus was therefore *unlike* most dividends.

* Wood & Porter, P.C., San Francisco, CA.

Furthermore, companies tie compensation to profits to increase a manager's incentive to increase them. The Seventh Circuit went so far as to rebuke the Service for questioning a compensation arrangement that had been in effect for decades. By attacking a longstanding arrangement only in a year in which Mr. Menard had achieved outsize profits, the Service was cherry-picking.

As to the savings clause, the Seventh Circuit had no difficulty in finding it to be prudent for the company, and bad for Mr. Menard personally. Besides, such savings provisions are common.

Keeping Up with the Joneses

The Tax Court's primary focus in holding Mr. Menard's compensation excessive was comparability. How much were comparable CEOs paid in 1998? Other CEOs were paid only $2.8 million (Home Depot) and $6.1 million (Lowe's), and those companies were larger than Menards.

The Tax Court arrived at what it thought was a reasonable figure of $7.1 million by formula. It allowed Menard as reasonable compensation an amount slightly more than twice the salary he supposedly would have earned had he been Home Depot's CEO (had Home Depot enjoyed as high a return on investment as did Menards). The Tax Court viewed investor rate of return analysis as driving CEO compensation. It excepted out random factors, and came up with a number it felt was fair.

The Tax Court was surely trying to do a good job in its economic analysis, but it got little credit from Judge Posner. In fact, he labeled the Tax Court's machinations "arbitrary as well as dizzying," particularly for disregarding the differences in the full compensation packages of the three executives it compared. Besides, said the Seventh Circuit, the Tax Court took no account of the different challenges faced by the companies, the different responsibilities of its CEOs, and their different performance. One must compare apples to apples.

The Tax Court even failed to compare the amount of work the three CEOs did. Judge Posner noted that Menard was a workaholic, headed his own company, and routinely performed tasks that would have kept a whole team of people busy at a similarly situated company!

New Standards?

To my mind, Judge Posner was right. One can hardly evaluate the intensely factual and amorphous "how much is reasonable" question without looking closely at exactly who did what, over what period of time, and with whom. There are probably half a dozen good reasons the Seventh Circuit could have reversed the Tax Court decision in *Menard*.

Although a closely held company's motives might well be questioned, the Seventh Circuit was right that this bonus arrangement was longstanding. The Service seemed plainly to be cherry-picking, and not doing so fairly. Taxpayers and their advisers should perk up from this case.

But after all the hubbub, will reasonable compensation standards now change?

The jury is still out, but *Menard* could be a bellwether case. The Tax Court has generally applied a number of factors in assessing reasonableness—the employee's qualifications and contributions to the company, the employee's salary history, dividends paid, market standards, etc. The Seventh Circuit previously rejected the Tax Court's multifactor approach in favor of a single independent investor inquiry. *See Exacto Spring v. Commissioner*, 196 F.3d 833 (7th Cir. 1999).

The independent investor test asks whether a hypothetical independent investor would consider the rate of return on his investment to be far higher than he had any reason to expect. If the hypothetical independent investor can clear that hurdle, the compensation paid is presumptively reasonable. Even then, such a presumption can be rebutted by evidence that the company's success was the result of extraneous factors (unexpected discovery of oil under its land, for example), as opposed to being directly attributable to the employee in question.

"Independent investor" inquiries have also been made in other circuits, including the Second and Ninth. Although it may be a reasonable line of inquiry, it should clearly not be definitive. Deciding whether compensation is reasonable usually involves a more amorphous facts and circumstances test that takes the entire mix into account. That is as it should be. One of my favorite passages in Judge Posner's opinion in *Menard* is the notion that if the company had lost money in 1998 (even if it was not his fault), the founder's total take-home pay would have been only $157,500, less than the salary of a federal judge!

There are usually incentives for a closely held company to pay deductible compensation rather than non-deductible dividends. Nevertheless, the Seventh Circuit even took a swipe at these traditional incentives. It noted that under the 2003 tax law changes, the tradeoff between dividends and salary has become more complex. After all, the maximum tax rate for dividends is now lower than the maximum tax rate for salaries.

As a poignant comment on tax incentives, the Seventh Circuit observed that under such rules, a company unable to deduct a $17.5 million bonus would have paid $6.1 million in additional income tax. Had Mr. Menard received such a bonus as a dividend and thus paid 15% (rather than 35%) in tax, he would have saved only $3.5 million. With current rates, the recharacterization dance is simply not the tax bonanza the Service attack seemed to suggest. It is unclear how much of the reasonable compensation debate going forward will focus on such issues.

Conclusion

For most of us representing closely held businesses, *Menard* is a great case, restoring much of the confidence that many such taxpayers have in the validity

of their compensation arrangements. It is good for the companies and the workers, with the kind of identity of interest that often permeates representing closely held businesses. There will always be some concern when compensation appears to be outsize and where "disguised dividend" earmarks may be present. Yet in many (if not most) cases, the following mix of the totality of the circumstances will probably make everyone feel comfortable:

- Compensation arrangement and contract struck prospectively, not retroactively;
- Compensation, even in outsize years, considered across the historical perspective that may include inadequate compensation in the past;
- Comparative data about other similarly situated companies;
- Comparative data about other similarly situated executives;
- Personal effort expended, regardless of what other executives may do;
- Dividend history; and
- Capital investment criteria for an independent investor. ■

Is Your Exempt Organization Meeting the Rebuttable Presumption? It's Time for Tax-Exempt Hospitals to Review Their Compensation Policies

By Heather Szajda and Derek Kung*

In May 2006 the Service commenced its "Hospital Compliance Project," providing exempt organizations a glimpse of what issues may be of concern to it. The project focused on community benefit and executive compensation. Based on past reporting, the Service also examined the compensation practices of 20 hospitals. Nearly three years later, the Service has issued its final report, which indicates a likely increase in scrutiny of the initial contract exception and the rebuttable presumption.

Tax-exempt organizations are prohibited from excessively compensating their employees, officers, and directors. An excess benefit transaction is defined as a "transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person, and the value of the economic benefit provided exceeds the value of the consideration (including the performance of services)." Treas. Reg. § 53.4958-4(a). If compensation is deemed an "excess benefit," then Code section 4958(a) imposes a penalty equal to 25% of the excess benefit amount upon the disqualified person.

Mechanisms for Protecting Against the Excess Benefit Prohibition

Exempt organizations often rely on the initial contract exception when first hiring an executive and then comply with the requirements of the rebuttable presumption in successive years when determining said executive's compensation. The excess benefit prohibition applies to a "disqualified person," which Regulation section 53.4958-3(a) defines as someone who was in a "position to exercise substantial influence over the affairs" of the exempt organization. Because of the substantial influence requirement, the Regulation's initial contract exception excepts from Code section 4958 "any fixed payment made to a person pursuant to an initial contract." To qualify for the initial contract exception, the compensation arrangement must satisfy the following criteria: (1) the executive may not be a disqualified person prior to entering into the contract with the organization; (2) the contract provides a fixed formula for determining the executive's compensation; (3) the compensation must be for specified services or property; (4) no person can exercise discretion as to the amount of compensation or whether to pay or not pay compensation; and (5) the executive must substantially perform such executive's obligations under the contract. Treas. Reg. § 53.4958-4(a)(3)(i)-(iv).

* Heather Szajda and Derek Kung are associates in the Richmond, VA, office of Williams Mullen.

For years, tax-exempt organizations have relied on Regulation section 53.4958-6, as a safe harbor when setting executive compensation. Regulation section 53.4958-6(a) provides a rebuttable presumption of reasonableness if (1) the compensation arrangement is approved in advance by an authorized body of the tax-exempt organization composed of individuals who do not have a conflict of interest with respect to the arrangement, (2) the authorized body obtains and relies upon appropriate comparable data prior to making the determination, and (3) the authorized body contemporaneously documents the basis for the determination at the time the decision is made. The three-prong requirement for the rebuttable presumption should be the minimum standard a tax-exempt organization incorporates into a compensation policy that is followed for setting compensation of employees, officers or directors (collectively, "employees").

A tax-exempt organization should follow a compensation policy adopted by the governing body (the board of directors or trustees) of the organization for determining annually compensation of employees. The compensation policy should define the members of the authorized body, as provided under Regulation section 53.4958-6(c), as either the governing body of the organization, a committee of the governing body (as permitted under state law), or a committee comprised of members of the governing body and other parties authorized to act by the governing body under applicable state law. Members of the authorized body should be free from conflicts of interest with respect to the particular transaction.

A compensation policy should describe the comparability data the governing body deems appropriate for use as comparable data. Regulation section 53.4958-6(c)(2) provides that appropriate comparable data for determining reasonableness of compensation may include "compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; the availability of similar services in the geographic area of the applicable tax-exempt organization; current compensation surveys compiled by independent firms; and actual written offers from similar institutions competing for the services of the disqualified person." Many organizations obtain comparable data from information found on Forms 990 filed by similar organizations or use independent consultants or firms to advise on compensation in the applicable industry.

Lastly, Regulation section 53.4958-6(c)(3)(i) requires decisions concerning compensation be documented adequately by the authorized body. The regulation requires that adequate documentation of the decision include written or electronic records of the authorized body that note: (1) the terms of the approved transaction and the date of approval; (2) the members of the authorized body present during the debate on the approved transaction and those who voted on it; (3) the comparability data obtained and relied upon by the authorized body and how the data was obtained; and (4) any actions taken with respect to consideration of the transaction by a member of the authorized body who had a conflict of interest with respect to the transaction. Furthermore, under Regulation section 53.4958-6(c)(3)(ii), "if the authorized body determines that reasonable compensation for a specific arrangement…is higher or lower than the range of comparability data obtained, the authorized body must record the basis for its determination." Documentation by the authorized body must occur contemporaneously.

If an organization creates a rebuttable presumption of reasonableness, the Service may still impose a penalty "if it develops sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the authorized body" under Regulation section 53.4958-6(b). For certain fixed payments under a contract, the Service may be limited to rebuttal evidence relating to the facts and circumstances as of the date the parties entered into an employment contract.

The Redesigned 990

In 2007, the Service announced that the Form 990 information return would be redesigned for the first time since 1979. Part VII of Form 990 requires disclosure of compensation of certain key individuals, and the Service has created a comprehensive Schedule J, which closely tracks compensation of such key individuals. Schedule J tracks all forms of compensation to certain key individuals, enabling the viewer to determine exactly how exempt organizations compensate such individuals. (Interestingly, the amounts reported in Part VII may differ from those in Schedule J. Schedule J requires inclusion of certain benefits and de minimis amounts not required to be reported in Part VII.) Part VI of the Form 990 requires exempt organizations to provide information regarding certain governance issues, such as the existence of a conflicts of interest policy or a compensation policy. Specifically, line 15 of Part VI requires organizations to describe the internal governance procedures it uses to satisfy the requirements of the rebuttable presumption. The instructions to the Form 990 state that "[e]ven though governance, management, and disclosure policies and procedures generally are not required under the Internal Revenue Code, the IRS considers such policies and procedures to generally improve tax compliance."

Findings of the Hospital Compliance Project

In a February 2009 summary report, the Service released the findings of the Hospital Compliance Project and noted several important findings: (1) nearly all the hospitals reported compliance with the regulations for meeting the rebuttable presumption of reasonableness for the compensation of employees, (2) the average and median compensation reported was $1,400,000 and $1,300,000 respectively for a focus

group of 20 hospitals that were selected for examination based on compensation amounts, and (3) although the compensation appears to be high, most of the amounts were upheld as established pursuant to the rebuttable presumption standard. Lois Lerner, in a press briefing issued on February 12, 2009, specifically addressed the compensation issue and the results of the Hospital Compliance Project and stated that the Service needs to closely examine the quality of comparability data used to establish reasonableness (specifically whether compensation amounts paid by for-profit organizations should be allowed) and the impact of the initial contract exception on compensation paid by hospitals.

Conclusion

While discussing the possibility of a trend in executive compensation of nonprofit hospitals moving toward the high end of the spectrum, the Service's TE/GE Commissioner, Steven T. Miller, stated (in an interview with the American Health Lawyers Association): "When the river rises, all boats rise. There's a question as to whether that was the intention of the rebuttable presumption concept." It appears that the issue of reasonable compensation will be a focus of the Service for the present time. Every tax-exempt organization should review its compensation policy to determine whether the policy appropriately incorporates the three-prong test set forth in Regulation section 53.4958-6, and sets forth standards that exceed the minimum for compensation data comparison. Hospitals should be on notice that the Service is looking carefully at compensation arrangements and consider whether past practices will continue to satisfy the rebuttable presumption standard. ■

Qualified Intermediary Program Reform

By Kathryn Morrison Sneade*

Last year, the qualified intermediary ("QI") program, which essentially allows foreign financial institutions to act as U.S. withholding agents by entering into an agreement with the Service and promising to abide by various terms, came under widespread scrutiny as a result of reported abuses of the program by the foreign banks UBS and LGT. As a result, proposals for reforming the program have been presented by the Service, the Senate Permanent Subcommittee on Investigation ("PSI"), and, most recently, the Obama administration. Many of these reforms would impose significant burdens on QIs, which will affect foreign financial institutions' ability and desire to participate in the QI program. However, the Obama administration's proposed reforms would also have serious negative consequences for non-QIs, leaving foreign financial institutions with a difficult choice.

Overview of the Program

The QI program was established in 2000 to encourage compliance with the U.S. withholding requirements of Code section 1441 and the corresponding Treasury regulations and to enhance reporting on U.S. persons' foreign account activity. Under the program, foreign financial institutions that have signed a QI agreement agree to take primary responsibility for withholding tax from payments to foreign persons and may also agree to take on primary Form 1099 responsibility for certain payments to U.S. persons. QIs must obtain a Form W-9 (indicating that the client is a U.S. person), Form W-8BEN (indicating that the client is a non-U.S. person who beneficially owns an account held in the name of an intermediary), or other appropriate documentation from each client that buys or sells U.S. securities through an account for which the foreign financial institution is a designated QI participant. All QIs are required to have "know-your-customer" ("KYC") procedures in place for collecting documentation regarding account holders' identities, and therefore, they are thought to be in a better position to accurately determine the residency and nationality of the account holders than other U.S. withholding agents.

As an incentive for financial institutions to join the program, QIs are not required to disclose the identities of non-U.S. account holders in the reporting and withholding process. Instead of filing an individual Form 1042S (used to report foreign persons' U.S. source income subject to withholding) for each non-U.S. client filing a W-8BEN form, QIs may pool the "reportable amounts" of U.S. source income paid to all non-U.S. accounts in the QI program and file a single Form 1042 for each category of U.S. source income paid to those accounts, remitting withheld taxes to the Service on an aggregate basis. In contrast, a QI that has taken on primary Form 1099 responsibility must file an annual Form 1099 with the Service for each U.S. client receiving "reportable payments" of U.S. source income in a QI-designated account. UBS and LGT reportedly helped many U.S. clients with U.S. securities avoid disclosure by helping them to establish foreign entities to hold the securities in a new account. The banks would then accept W-8BENs from the new accounts and treat them as accounts held by non-U.S. entities,

* Miller & Chevalier Chartered, Washington, DC.

although the banks were aware that the beneficial owners of the accounts were U.S. persons. It is a matter of debate whether such actions actually violated the banks' QI agreements, but lawmakers' perception of the banks' actions as abusive has given rise to a number of reform proposals.

PSI Recommendations

The PSI's recommendations for strengthening the program, presented in its Staff Report on Tax Haven Banks and U.S. Tax Compliance released in conjunction with its July 17, 2008, hearing, would attempt to address the issue of such abuse by requiring QIs to file a Form 1099 for every U.S. client and for all accounts beneficially owned by U.S. clients. In addition, QIs would be required to use all information obtained through their KYC procedures to identify the beneficial owners of accounts. The PSI also recommended strengthening external audits of QIs by requiring auditors to report evidence of fraudulent or illegal activity, a recommendation that the Government Accountability Office also made in a 2007 report on the QI program to the Senate Finance Committee. Finally, the PSI recommended the termination of QI status for tax haven banks that impede U.S. tax enforcement or fail to disclose accounts held directly or indirectly by U.S. clients. This would be inconsistent with the general approach taken by the Service in the past, which has been to work with QIs to remedy any compliance issues, rather than terminating their QI agreements, since the agreements generally allow the Service to collect taxes that otherwise might not be collected and also encourage investment in the U.S. by foreign account holders, as their identity is protected by the QI's pooled reporting. However, the PSI recommendations are in line with the approach reflected in the Obama administration's proposals, which take a similarly hard line with respect to tax evasion.

Service Proposals

The Service proposed changes to the program in Announcement 2008-98, issued in October 2008, as the first step in a multipronged plan to improve the program. (The Service has announced that it also plans to issue proposed section 1441 regulations to enhance documentation requirements, as well as a separate set of proposed regulations that would allow them to identify "bad actors," such as account holders whose documentation does not match up.) Announcement 2008-98 proposed three major changes to the QI program. First, a QI would be required to immediately inform the Service of any material failure of its internal controls relating to its performance under the QI agreement. Second, external auditors performing audits of QIs' performance would be required to collect additional information relating to the evaluation of the risk of a material failure of internal controls. Procedures for testing certain accounts for characteristics that suggest that a U.S. person has authority over the account would also be added. And finally, external auditors would be required to associate with audits a U.S. auditor who would accept joint responsibility for the performance of procedures under audit guidance.

These proposals have received a largely negative reaction from foreign financial institutions, which have expressed the view that foreign QIs have invested significant resources to ensure high levels of compliance with their obligations and that QI audits thus far have generally reflected satisfactory performance. In their view, the proposals are not necessary to ensure continued compliance by QIs, and the additional costly and time-consuming requirements proposed by the Service unfairly penalize compliant QIs and impose such significant burdens that many QIs may find it necessary to leave the program. For QIs that stay in the program, the significant additional costs of compliance will be passed on to customers, making U.S. investment less attractive.

Furthermore, a number of commentators have expressed the view that the Service should issue any proposed regulations enhancing the documentation requirements under section 1441 before making changes to the QI audit procedures, particularly any changes regarding testing accounts for authority of U.S. persons, as QIs currently have no special obligations with respect to accounts over which a U.S. person has authority.

The Administration's Reform Proposals

On May 4, 2009, the Obama administration presented several proposals for reforming the QI program as part of its plan to overhaul international tax policy. Consistent with the PSI recommendations for strengthened reporting by QIs, the administration's proposal would increase the reporting requirements for QIs. For instance, every QI would be required to file Form 1099s with respect to all "reportable payments" received on behalf of all U.S. account holders. Also, the Treasury Department would be authorized to issue regulations providing that QIs must collect information indicating the beneficial owners of foreign entity account holders and specifically report if the beneficial owner is a U.S. person. Additional reporting requirements would also be imposed on QIs and U.S. financial intermediaries regarding the establishment of or transfer of assets to foreign financial accounts and on QIs and U.S. persons regarding the establishment of offshore entities. Additional reporting requirements for QIs would provide a disincentive for foreign financial institutions to enter into QI agreements, as would regulations providing that a foreign financial institution may qualify as a QI only if all commonly-controlled financial institutions are also QIs. (The Obama administration's proposal would authorize the Treasury Department to issue such regulations.) However, the Obama administration's other proposals regarding the QI regime

would have significant negative consequences for non-QIs.

Other reforms proposed by the administration are based on a presumption that non-QI foreign financial institutions are facilitating tax evasion. Accordingly, U.S. financial institutions would be required to withhold 20 to 30% of U.S. payments to foreign individuals who use non-QIs. Investors entitled to a lower rate would have to prove their status to obtain refunds. There also would be a rebuttable evidentiary presumption that an account held by a U.S. citizen at a non-QI contains enough funds to require the filing of a Report of Foreign Bank and Financial Accounts ("FBAR"), and any failure to file an FBAR with respect to an account at a non-QI would be considered willful if the account had a balance of greater than $200,000 at any point during the year. In addition, U.S. individuals would also be required to report on their income tax returns most transfers of money or property made to or from non-QI accounts more than 50% owned, actually or constructively, by the individual. Reforms like this would make doing business with non-QIs unattractive for both foreign and U.S. investors.

Conclusion

The Service has indicated that it will announce final changes to the QI agreement and audit procedures "soon," and proposed regulations with respect to withholding are also expected "soon." It is likely to take some time for the PSI and Obama administration proposals to work their way through Congress, but it is clear that major changes are in the pipeline that will affect not only the QI program, but also foreign financial institutions generally. If many of the reform proposals are adopted, foreign financial institutions will be facing a difficult choice between participating in a QI program with increasingly burdensome requirements, some of which arguably push the limits of what the U.S. government can ask foreign financial institutions to do, and dealing with significant restrictions imposed on non-QIs, which would have major negative consequences for the financial institutions' ability to do business and attract customers. Altogether, the reform proposals are likely to advance the goal of preventing tax evasion, but it will be at the cost of alienating foreign investors and foreign financial institutions. ■

News Briefs

Section of Taxation White Papers

The Tax Section has created a series of White Papers that provide clear statements of tax policy issues that are important to the Section, and on which the Section has worked for many years. Some of the issues reflect the Section's policy advocacy positions that have been adopted by the ABA House of Delegates and are now reflected in tax-related ABA policies. Other issues may include information from specific Tax Section policies that have not been adopted by the ABA House of Delegates or its Board of Governors, and are specific only to the Tax Section. We hope that the papers will be useful to policymakers and the public, and will inform debate on these issues going forward. The following White Papers are available on the Section's website at www.abanet.org/tax/pubpolicy.

- Statement of Policy Regarding U.S. International Taxation
- Joint Statement on Tax Issues in Health Care Reform
- Statement of Policy Favoring Reform of Federal Civil Tax Penalties
- Statement of Policy Favoring Tax Simplicity, Stability, and Transparency

Important Developments Reports

As a service to its members, the Tax Section features on its website Annual Reports on Important Developments as well as interim updates presented by a number of committees at Section Meetings. These reports are an important work product of the Section's committees and track recent legislative changes, regulations, cases, and rulings, as well as forecast upcoming developments in over 30 substantive areas of the tax law. Reports for 2000-2008 are available. To access the online index, go to: www.abanet.org/tax/developments.

Tax Bridge to Practice for Law Students

The ABA Tax Section's Young Lawyers Forum is offering a Tax Bridge to Practice Program at the Section's Joint Fall CLE Meeting with the Trust and Estate Division of the Real Property Section. The event will be held on Thursday afternoon, September 24, 2009, in Chicago and is open to all 2L, 3L and LL.M. students in the area. The program will provide substantive lectures in tax by the best tax professors in the country, along with career advice and a series of practice-focused workshops. For more information, please contact the ABA Tax Section at 202-662-8680.

continued on back page

POINT & COUNTERPOINT

CCA 200911007 and the $1 Million Mortgage Interest Deduction Ceiling

Section 163(h)(3) allows taxpayers to deduct interest on acquisition indebtedness while section 163(h)(3)(B)(ii) provides that "[t]he aggregate amount treated as acquisition indebtedness shall not exceed $1,000,000 ($500,000 in the case of a married individual filing a separate return)."

In Chief Counsel Advisory (CCA) 200911007 (Mar. 3, 2009), the Service addressed the amount of interest that was deductible as "qualified residence interest" under section 163(h)(3)(A) when a residence encumbered by a purchase money mortgage of more than $1,000,000 is co-owned by two unmarried taxpayers both of whom are obligated on the mortgage and for both of whom the residence is the principal residence. The Service concluded:

> Under § 163(h)(3)(B)(i), acquisition indebtedness is defined, in relevant part, as indebtedness incurred in acquiring a qualified residence of the taxpayer – not as indebtedness incurred in acquiring taxpayer's portion of a qualified residence. The entire amount of indebtedness incurred in acquiring the qualified residence constitutes "acquisition indebtedness" under § 163(h)(3)(A)(i). In this case, the amount of indebtedness incurred in acquiring [the residence] exceeds $1,000,000. However, under § 163(h)(3)(B)(ii), the amount treated as acquisition indebtedness for purposes of the qualified residence interest deduction is limited to $1,000,000 of total, "aggregate" acquisition indebtedness. This is evident from the parenthetical in § 163(h)(3)(B)(ii) which limits the aggregate treated as acquisition indebtedness to $500,000 for a married taxpayer filing a separate return.

Professor Patricia Cain argues that the CCA was wrongly decided and that the $1,000,000 ceiling should be applied on a "per taxpayer" basis. Professor Martin McMahon argues that the $1,000,000 ceiling on acquisition indebtedness applies both on a residence-by-residence and taxpayer-by-taxpayer basis.

NewsQuarterly encourages readers to submit responses or comments which may be published in a subsequent issue.
— Christopher M. Pietruszkiewicz, Vice Chancellor for Business and Financial Affairs and J.Y. Sanders Professor of Law, LSU Law Center, Baton Rouge, LA

POINT

CCA 200911007 and the $1,000,000 Limitation on Mortgage Interest Deductions: Two Wrongs Don't Make a Right

By Patricia A. Cain*

Two unmarried taxpayers co-own their principal residence. They are both liable on the $2,000,000 purchase-money mortgage. They split the monthly payments equally so that each owner pays interest on a total of half of the mortgage. Each claims an interest deduction for 100% of the interest that each owner paid on $1,000,000 of acquisition indebtedness. In CCA 200911007, the Office of Chief Counsel advised that the deductions claimed by the two unmarried taxpayers are improper. Because the total acquisition debt on their residence exceeds $1,000,000, they should be limited, between them, to interest paid on $1,000,000.

Under the CCA, the Service will apply the $1,000,000 ceiling on debt that may be treated as "acquisition indebtedness" on a "per residence" basis. By contrast, I believe the only sensible way to apply the ceiling is on a "per taxpayer" basis. The fact that married taxpayers are limited to a ceiling of $1,000,000 between them is not sufficient reason to limit two (or more) unrelated, unmarried taxpayers who co-purchase a residence to a single ceiling of $1,000,000.

The problem arises because of an inartfully drafted statute. In 1986, Congress repealed the deduction for personal interest generally, but preserved the deduction for qualified residence interest. In 1986, no dollar maximums were placed on the amount of "qualified residence interest" that could be deducted. Taxpayers could deduct 100% of all acquisition debt, as well as 100% of any home equity debt that was used for qualified medical or educational expenses, provided the aggregate amount of such indebtedness did not exceed "the lesser

* Inez Mabie Distinguished Professor of Law, Santa Clara University, Santa Clara, CA.

of" either "the fair market value of [the] qualified residence" or "the sum of … *the taxpayer's basis* in [the] qualified residence … plus … [t]he aggregate amount of *qualified indebtedness of the taxpayer* with respect to [the] qualified residence." I.R.C. § 163(h)(3)(B) (emphasis added) as originally enacted by the Tax Reform Act of 1986.

The clear referent for determining the limitation in 1986 was the taxpayer. Each taxpayer's limit was to be computed by reference to the lesser of the fair market value of the *taxpayer's* residence or the *taxpayer's* basis in that residence. The fair market value limitation was enacted to ensure that no taxpayer could deduct mortgage interest on aggregate debt that exceeded the property's fair market value. The only sensible way to apply this limit in cases involving multiple ownership would have been to consider each taxpayer's fair market value and basis, rather than aggregate fair market value, indebtedness, or basis. For example, if taxpayer A had purchased a home in 1986 for $3,000,000, incurring a mortgage liability of $2,000,000, and then had sold a 50% interest in the home to a cohabitant, taxpayer B, for $1,500,000 in cash, how would we measure A's limit—by his individual basis in his half or by aggregate basis? Should the fair market value limitation be the fair market value of the property or the fair market value of his individual share? The most reasonable answer is that he should be limited to interest deductions on $1,500,000 of the $2,000,000 mortgage debt because that is his individual basis. The limit is applied per taxpayer because Congress did not want to give any taxpayer an interest deduction on mortgage debts that exceeded the fair market value of what the taxpayer owned. Nor did Congress want to authorize deductions on mortgages in excess of basis except in the case of qualified home equity indebtedness, which had to be used to pay educational or medical expenses.

The changes made in 1987 retain the underlying principle of the 1986 statute by limiting the amount of the deduction to "acquisition indebtedness," which will almost always be no more than the fair market value of the property, plus a limited amount of home equity indebtedness ($100,000 maximum). The 1987 statute provides an additional limit: acquisition indebtedness cannot exceed $1,000,000. Since the 1986 limitation applied "per taxpayer" and not "per residence," it is reasonable to conclude that the 1987 limitation of $1,000,000 should also be applied "per taxpayer." The only reason given for the $1,000,000 limitation was "to limit the benefits of the interest deductions in the case of high-income persons." H.R. Rep. No. 100-391 (II), as reprinted in 1987 U.S.C.C.A.N 2313-378, 2313-648. This statement suggests that the limit was intended to be applied "per person" and not "per residence."

The Service supports its construction of the statute by claiming that "acquisition indebtedness" is debt incurred to acquire a "residence" and not a "portion of a residence." Yet, in determining which residences qualify under section163(h)(3), the statute refers to section 121, a provision which clearly treats a co-tenant's interest in a residence as a residence. Furthermore, the only regulations that have ever been drafted under section 163(h)(3) provide that jointly-owned property under a time-sharing arrangement will qualify as a personal residence of the taxpayer. *See* Treas. Reg. § 1.163-10T(p)(6). The portion of the residence that will qualify is the taxpayer's time portion. Thus, a taxpayer who borrows $1,000,000 to purchase three months out of twelve months of a time-share vacation home appears to have a qualified acquisition debt of $1,000,000 regardless of how much additional acquisition debt is outstanding on the entire residence. In this case, the $1,000,000 limitation is applied "per taxpayer" rather than "per residence."

Housing prices in the San Francisco area are so high that many first-time home buyers cannot afford to enter the market for single homes. It is becoming a common practice for unmarried taxpayers to purchase a home together, sharing the liability for the mortgage payments in proportion to their ownership interests. The practice has become common enough that an entire real estate market has developed, offering tenancy in common ownership (TICs) in homes that either have separate units or can be adapted to provide separate living spaces. TIC purchasers typically assume a portion of a pre-existing acquisition debt that often exceeds $1,000,000, although a few banks have begun to offer separate financing for TIC purchases. The mere fact that people cannot afford to buy the homes that they want unless they can share the cost with others should not prevent them from claiming an interest deduction on the portion of the mortgage they can afford to pay. Yet, if the aggregate acquisition debt exceeds $1,000,000, the CCA would appear to limit the deductions of individual taxpayers.

The rules in section 163(h) do create a marriage penalty. The parenthetical in section 163(h)(3)(B)(ii) limits acquisition debt for married individuals who file separately to $500,000. The statute is silent as to the limit that applies to married couples who file jointly. However, in 2001, the Service concluded "that Congress did not intend to treat married couples filing jointly differently than married couples filing separately." FSA 200137033 (Sept. 14, 2001). As a result, the maximum amount of acquisition indebtedness on which a married couple can claim interest deductions is $1,000,000. (A similar rule applies to the $100,000 limit for home equity indebtedness.)

There is one additional marriage penalty in section 163(h)(4). Each taxpayer is entitled to interest deductions on qualified debt incurred on a principal residence and one other personal residence. The statute provides that married taxpayers who file separately shall be treated as one taxpayer with respect to this rule. Thus, between them they can only claim interest deductions on indebtedness secured by a maximum of two homes. FSA 200137033

extends this two-home limit to married taxpayers who file jointly.

In each of the following examples illustrating the marriage penalties, A and B are initially unmarried:

- A and B each owns a principal residence and one additional home, with $500,000 of acquisition debt outstanding on each of the four homes. They each can deduct 100% of the interest they pay. But the moment they marry, they will become limited to interest deductions on only two of the homes and on a maximum of $1,000,000 out of the $2,000,000 of their aggregate acquisition indebtedness.
- A and B each owns a principal residence with $1,000,000 of acquisition debt outstanding on each residence. They each can deduct 100% of the interest they pay. But the moment they marry, their combined interest deductions will be cut in half because, as spouses, they will be limited to aggregate acquisition debt of $1,000,000 between them.
- As in the CCA, A and B co-purchase a single residence, with each of them borrowing $1,000,000 to acquire their interest. If the $1,000,000 limitation is applied "per taxpayer," as I believe it should be, each taxpayer will be entitled to deduct 100% of the interest paid. But the moment they marry, they will be treated as one taxpayer, limited to $1,000,000 of acquisition debt between them.

By construing section 163(h)(3) to provide a $1,000,000 ceiling "per residence," the Service has removed the marriage penalty in the third example, but not in the first two. The marriage penalty is built into the entire statute because Congress elected to treat all married couples the same. This principle of marriage equality became a basic principle in our tax law when Congress adopted joint returns in 1948. It often produces marriage penalties for two-earner couples by treating them the same as one-earner couples. Since a married couple that consists of only one taxpayer (i.e., one earner and one dependent spouse) would be limited to $1,000,000 of acquisition indebtedness (and two residences), the principle of marriage equality would require imposition of the same limits on a two-taxpayer married couple.

The best explanation for the Service position in the CCA is a concern about the marriage penalty. But adopting a "per residence" limit for the $1,000,000 ceiling on acquisition debt is not the right way to remedy that concern. If it is wrong to have a marriage penalty in section 163(h)(3), then Congress ought to remedy the problem directly by considering the larger policy question of how two taxpayers, married to each other, ought to be treated compared to (1) a taxpayer who is married to a dependent, non-taxpayer spouse; and (2) two unmarried taxpayers. If the section 163 marriage penalty is wrong, it does not make it right to extend the rule that creates the penalty to unmarried taxpayers who, for whatever reason, co-purchase a principal residence. Two wrongs do not make a right.

COUNTERPOINT

CCA 200911007: Trying to Make Sense of the $1,000,000 Ceiling in the Home Mortgage Interest Deduction Rules

By Martin J. McMahon, Jr.*

Many commentators in the debate on the rectitude of CCA 200911007 have described the CCA as holding that the $1,000,000 limitation on the deduction of mortgage interest on acquisition indebtedness under section 163(h)(3)(B) applies on a per-mortgage basis. Some of the commentators have asserted that, prior to the issuance of this CCA, there was a general assumption that unmarried co-owners could each deduct mortgage interest on $1,000,000 of acquisition indebtedness, thus permitting deduction of interest on a $2,000,000 mortgage on a home they owned in common and that the CCA is wrong. They have taken this position notwithstanding the conventional wisdom for the twenty some years since the present version of section 163(h)(3) was adopted in the 1987 amendments to section 163(h) that a married couple filing a joint return was entitled to deduct interest on only $1,000,000 of acquisition indebtedness. (Nevertheless, in administering section 163(h), Service guidance states that "debt you incurred to buy, build, or substantially improve your home, to the extent that it is more than the home acquisition debt limit, may qualify as home equity debt." Publication 936, *Home Mortgage Interest Deduction* 9 (2008). This interpretation allows a deduction for interest on a purchase money mortgage of up to $1.1 million.)

I disagree with the commentators who have so described the holding of CCA 200911007 and who have criticized it as an incorrect interpretation of the statute. I read the CCA to hold that the $1,000,000 ceiling on "acquisition indebtedness," as defined in section 163(h)(3)(B), applies on *both* a residence-by-residence basis and a taxpayer-by-taxpayer basis.

The CCA addressed the tax consequences of only one of the co-owners—the one who originally owned the property in fee simple and was solely obligated on the mortgage and who subsequently conveyed an undivided ownership interest to a second person who also became obligated on the

* Stephen C. O'Connell Professor of Law, University of Florida, Fredric G. Levin College of Law, Gainesville, FL.

mortgage. The CCA concluded that under the formula in Regulation section 1.163-10T(e), the interest deductible by the taxpayer in question was to be determined by multiplying the amount of interest paid by a fraction, the numerator of which is $1,000,000 and the denominator of which is the amount of the mortgage. If, for example, the mortgage was $1,500,000 and the taxpayer paid $75,000 of interest, the amount of the taxpayer's interest deduction would be $50,000 ($75,000 x ($1,000,000 ÷ $1,500,000)). This formula should work, because if one of several jointly obligated joint owners of property pays more than a ratable share of otherwise deductible interest, a deduction is allowable for the full amount paid. *See Mason v. United States*, 453 F. Supp. 845 (N.D. Cal. 1978); *Finney v. Commissioner*, 35 T.C.M. (CCH) 1504 (1976).

There is a good argument that the reasoning and conclusion of the CCA limiting to $1,000,000 the amount of "acquisition indebtedness" that can be taken into account collectively by all of the owners of the residence is correct. The legislative history (H.R. Rep. No. 100-391 (II), at 1031-34 (1987); H.R. Rep. No. 100-495, at 916-17 (1987) (Conf. Rep.)) provides no useful guidance, but a careful reading of the statutory language indicates that because section 163(h)(3)(B)(ii) omits any reference to a "taxpayer," it limits to $1,000,000 the aggregate amount of "acquisition indebtedness" that may be taken into account in determining the amount of "qualified residence interest" with respect to all of the taxpayers that might reside in that dwelling unit.

Section 163(h)(2)(D) and (3)(A) excepts from the general rule of section 163(h)(1) disallowing a deduction for personal interest, "qualified residence interest." "Qualified residence interest" is defined in section 163(h)(3)(A) to mean "acquisition indebtedness with respect to any qualified residence of the taxpayer," and certain home equity indebtedness. Section 163(h)(3)(B)(i) in turn defines "acquisition indebtedness" as "indebtedness which ... is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, and ... is secured by such residence." But section 163(h)(3)(B)(ii) provides that "[t]he aggregate amount treated as acquisition indebtedness for any period shall not exceed $1,000,000 ($500,000 in the case of a married individual filing a separate return)."

If the $1,000,000 ceiling does not apply on both a residence-by-residence and a taxpayer-by-taxpayer basis, and each taxpayer who resides in the residence is an owner and is obligated on the "acquisition indebtedness" mortgage is entitled to deduct interest paid on up to $1,000,000 of acquisition indebtedness, then on a joint return each of the husband and wife would be entitled to deduct interest on up to $1,000,000 of "acquisition indebtedness." That is true because notwithstanding the filing of a joint return, a husband and wife are separate and distinct taxpayers. *See, e.g.*, *Frahm v Commissioner*, 94 T.C.M. (CCH) 504 (2007). But the statute clearly does not contemplate that result, as evidenced by the limitation on the deduction to the interest on $500,000 of acquisition indebtedness by married taxpayers who file separately. The parenthetical indicates, even though it does not expressly state, that a husband and wife who each own a one-half interest in the residence and are jointly and severally liable on the mortgage can deduct interest on only $1,000,000 of acquisition indebtedness. Furthermore, in *Pau v. Commissioner*, 73 T.C.M. (CCH) 1819 (1997), the Tax Court held that a married couple filing jointly was entitled to deduct only the interest attributable to $1,000,000 of an acquisition loan, the outstanding principal balance of which was $1,330,000. Thus, the only precedent as of now holds that a husband and wife are not each allowed separately to deduct interest on up to $1,000,000 of acquisition indebtedness where total acquisition indebtedness of their joint principal residence exceeds $1,000,000. (Concededly, it does not appear that the taxpayers in *Pau* argued that each of the husband and wife were entitled to deduct interest on up to $1,000,000 of acquisition indebtedness.) An interpretation of the statute that applies the $1,000,000 ceiling on "acquisition indebtedness," as defined in section 163(h)(3)(B), on both a residence-by-residence and a taxpayer-by-taxpayer basis avoids this "marriage penalty" that would otherwise arise.

Some have proffered the argument that the cross reference to section 121 in section 163(h)(4) for the definition of a "principal residence" incorporates the provisions of Regulation section 1.121-2(a)(2), applying the $250,000 exclusion on a per-taxpayer basis in a co-owner situation. This argument should not carry any weight whatsoever. The cross reference does not incorporate calculational methodology, but merely the definition of principal residence. When section 163(h) was enacted in 1986, and the relevant amendments adopted in 1987, former section 1034 provided rollover for gains on the sale of a principal residence. With the enactment of section 121 in 1997, section 163(h) was amended just to change the cross reference from section 1034 to section 121. The only purpose of the cross reference is to invoke rules for distinguishing a "principal residence" from a "secondary residence."

Section 163(h)(4)(A) "treats" a husband and wife filing separate returns as a "single taxpayer" for purposes of determining the number of qualified residences and limits them collectively to two residences. I don't think the parenthetical in section 163(h)(4)(A) can by inference convert a husband and wife into a single taxpayer if they do not file a separate return. Core doctrinal tax law is that husband and wife, even if they file a joint return, are two separate and distinct taxpayers whose items are aggregated. Various Code sections, such as sections 267 and 1041, can alter the timing and recognition rules, etc., but

they are overrides. Various Code sections can expressly provide an allowance, ceiling, or floor on a particular item on joint returns that differs from double that on returns of single taxpayers, but they are all express, not inferred. Section 163(h)(4)(A), coupled with the parentheticals in section 163(h)(3)(B)(ii) and 163(h)(3)(C)(ii) can as easily, maybe more easily, be read as an express penalty on married taxpayers who file separate returns.

It is possible that the origin of the difficultly in interpreting the statutory language very well might lie in the drafters of the 1987 amendment to section 163(h) erroneously believing that married individuals filing a joint return as a matter of doctrinal law were converted into one unitary taxpayer. That is incorrect, but the same error led to some strange language in section 121(d)(1) that is discussed in an article I published shortly after section 121 was enacted. *See* Martin J. McMahon, Jr., *Taxation of Sales of Principal Residences After the Taxpayer Relief Act of 1997*, 75 TAXES 610 (Nov. 1997). It is also possible that the drafters of section 163(h)(3) might have failed to contemplate the fact pattern in the CCA. In 1987, these issues had been little discussed by tax professionals, with the exception of some in academia, and if the discussion was only in a mainstream law review, no one writing the statutory language was aware of it.

Thus we are forced to try to figure out the meaning of statutory language that very well might have been drafted on an erroneous premise regarding the default meaning of the word "taxpayer" in a Code provision, and which possibly never contemplated two single taxpayers co-owning a home with a purchase money mortgage. In the end, I think the words of the statute are better construed to mean that the $1,000,000 ceiling is both per physical residence unit and per taxpayer, than to mean that the statute creates a marriage penalty when two singles who co-own a principal residence with a $2,000,000 purchase money mortgage get married and file a joint return, thereby losing one-half of their interest deduction because the joint return is limited to interest on a $1,000,000 mortgage. Construing the statute to allow a husband and wife on a joint return to claim deductions for interest on a $2,000,000 mortgage but allowing them a deduction on only a $1,000,000 mortgage if they file separately is the least likely plausible construction.

There is one conclusion of which I am certain. It is inconceivable that Congress intended to allow two unmarried taxpayers who share a principle residence each to deduct interest on acquisition indebtedness of up to $1,000,000, for a total of $2,000,000 of acquisition indebtedness, while limiting married couples filing jointly to a deduction for interest on acquisition indebtedness of up to only $1,000,000. Unless the statutory language unambiguously compels that result, any interpretation of the statute that reaches that result is likely to be rejected by the courts. Thus, the most reasonable conclusion is that if challenged, the Service's conclusion in CCA 200911007 likely will be sustained. ■

POINT & COUNTERPOINT | COST OF LIVING ADJUSTMENTS *continued from page 11*

Our analysis shows horizontal equity cannot be classified by region, i.e., we cannot say the Northeast is more/less equitable than the Southwest. However, considering taxpayers who own homes, we observe the states that are the most inequitable tend to be in the coastal areas. Likely, this is a reflection of the cost of living disparities between areas within the state. The states where renters have the most inequity are more scattered. Interestingly, there are only eight states whose Coefficient of Variation Ratio (the measure we used for HE) for this group of taxpayers is above the federal average (i.e., has worse horizontal equity) for both owners and renters: California, Colorado, Florida, Hawaii, Montana, New York, North Dakota, and Vermont.

In a perfect HE world, the United States would be economically homogeneous within income bands. Of course, this is not the case. The size and diversity of the United States is arbitrary and changes over time, yet the Code applies the same law to everyone regardless of location. Changes in tax prices, like all prices, are caused in part by changes in space (geography) and time (inflation). Congress has been much more aggressive addressing the inequities caused by inflation. They have, for the most part, neglected the very real inequities caused by geographical differences within the United States.

Policy recommendations must be weighed against increases in complexity and compliance burdens. One fairly easy way to eliminate some of this inequity is to create different federal income tax brackets for each state or city that would take into account the federal tax subsidy due to, for example, housing cost differences. We anticipate that different tax rate schedules would be needed for different taxpayers (e.g., itemizers vs. non-itemizers or renters vs. homeowners) for a particular location, which would add some complexity (and possible political problems) and may create new tax avoidance schemes. For those states that have a tax system that is derived from federal tax law, this change could prove problematic.

Another possibility would be to eliminate the mortgage interest, property tax, and state income tax deductions for all taxpayers, if these variables are causing variances in horizontal equity, while

at the same time lowering tax rates. A further way to reduce HE variability is to place deduction caps on the variables that are responsible for the differences, once they are known. Specific policy recommendations can be made when we know more about the variables creating the geographical differences in HE. This will require further research.

COUNTERPOINT

The Inequities in Cost of Living Adjustments

By Calvin H. Johnson*

Professors Angelini and Noga propose to reduce tax in high cost of living locations and shift the tax burden to low cost of living locations. Cost of living varies across locations for many reasons. For most of the reasons, adjusting the tax base to take away the variations in cost of living would be terribly inequitable.

Cost of living, first, is the purchase price for amenities. People bid up the price of New York City living space to get access to the opera, dance, theater, symphony, extraordinary French restaurants, and professional sports. In the desert, there is no such access. Similarly, the cost of real estate is higher in southern California than in northern Minnesota because the weather is better on the California coast. People buy sunshine and temperate weather by bidding up the price of limited California coast land. By contrast, you can get space cheaply in rat-infested, falling down houses in crime-ridden, polluted neighborhoods with bad schools, bad weather, and bad access to transportation. If you are willing to put up with a three-hour commute to center city, then the cost of living will go down.

The relative value of the costs across the country is kept in equilibrium by the high level of geographical mobility in this country. According to the Census, 38 million people moved in 2007 and almost six million of them moved to a different state. Each household that moves must make the judgment as to what is the best value to be had for the money allowed by its budget. The moving households bid up the more attractive locations and do not bid for the less attractive locations until the price comes down. People who are settled have a strong psychological tendency not to move. Those who do move are market makers who set the price between their choices. Settled taxpayers can rely on the movers to keep the relative price of a location more or less in equilibrium. Given that settled taxpayers do not move, moreover, they must get even more value from their current location than is reflected in the price of their house. You get by and large what you pay for in an open competitive market. The market price of a location comes to reflect the advantages and the disadvantages of the location in which one lives.

If people are getting full value for their higher costs, it would be inequitable to filter that out of the tax system. Indexing to take the costs of amenities out of the tax base would reduce tax on those who pay for a rich full life in sunshine or excitement and shift the tax burden, inequitably, over to those who live with rats, pollution, bad schools, crime, cold, parched land, or long commutes.

Cost of living is also correlated with wealth. Rich people move into desirable neighborhoods and drive up the price. Restaurants and recreation follow the rich so that the non-housing budget is higher in those locations as well. On the other side of the coin, the poor get priced out of desirable locations and move to old housing in crime-ridden or polluted neighborhoods, or to parched land with long commutes, because that is what they can afford.

Some of the differentiation between the locations of the rich and less rich is already tax driven. The tax subsidies for housing in the form of the home mortgage interest deduction, the deduction of property taxes, and the failure to tax the noncash rental-value return from investing in housing have a value that depends upon tax brackets. In neighborhoods where purchasers are in the 35% tax bracket, the price of the house will come to reflect at least some of the tax subsidy because existing homeowners selling their houses try to capture as much of the value of the tax subsidy as they can. When purchasers are in lower brackets or get no tax savings from itemized deductions, there is less tax savings for selling homeowners to capture. The deductions for interest and property taxes and exclusions for real return from investment in a home plausibly already reflect too much of the variable cost of housing. Equity might well be improved by taxing *more* of the difference in cost of living, not less.

Because of the migration of rich and less rich, and the differential tax benefits reflected in price, zip codes over time come to be richer than average, or disproportionately poorer. Indexing for cost of living per zip code, under those circumstances, will shift tax away from the wealthier, who can more comfortably bear another dollar of tax, and over to less wealthy taxpayers, from whom another expense, including tax, would be devastation. Shifting the tax burden from richer to less rich would increase the damage that tax does to the sum of human happiness.

Another part of the difference in cost of living is costs of transporting goods. Oranges are more expensive in the North, beef is more expensive on the coasts, and toys and electronic goods are more expensive the farther you live from China. In general, consumption costs, including the embedded transportation costs, are personal expenses that properly are not deductible. An even tax on all consumption reduces private consumption across the board. It is the suppression of private consumption that allows room for public spending. I don't see why the government should subsidize the transportation component of consumption by treating it better than other personal costs.

* Professor of Law, University of Texas School of Law, Austin, TX.

Cost of living can sometimes be plausibly treated in part as an expense for the production of income, and then there is a more reasonable case for deduction. People move where the jobs are in order to make higher wages, sometimes even when the pleasures of the new location are a lot worse than the amenities of the old. Section 162(a)(2) allows a deduction for meals and lodging while away from home, on the grounds that such meals and lodging are atypically expensive. Cost of living adjustments can be rationalized as just a liberalization of section 162(a) to include expensive meals and lodging while not away from home. I have expressed doubt that section 162(a)(2) is good policy—consumption is a personal expense that needs to taxed whatever its context. Calvin H. Johnson, *An Employer-level Proxy Tax on Fringe Benefits*, 123 Tax Notes 483 (April 27, 2009). Still, Professors Angelini and Noga undercut the best case for the deduction, by arguing that there is no "*immediate* theoretical connection" between the costs of living in an area and the wages paid. An immediate nexus between costs and taxable wages would improve their case.

Once you take amenities, wealth, and transportation costs out of the mix, there may not be any adjustments left in cost of living differentials. If it exists, we may not be able to identify residual cost of living differential. Professors Angelini and Noga analogize between indexing the tax brackets for time variations in cost of living—what we call "inflation"—and indexing the tax brackets for geographical variation in the residual cost of living. Of course, one can not avoid inflation by moving around in time, whereas you can avoid a high cost of living or adjust your costs to your preferences by moving around geographically.

Even considering the residual differences in cost of living not explained by amenities, wealth, or transportation, a good case can be made for *increasing* tax in the high cost of living areas. The government needs a dollar to close the deficit, pay for the Marines, or whatever. To the government, the dollars are the same no matter where they come from. If a dollar buys less value in high cost of living locations, we should collect more tax from those locations. The science of tax is the science of taking dollars away that do the least harm to private utility, and taking dollars away from places where the dollar buys less will do less harm.

Professors Angelini and Noga set up a "Coefficient of Variation Ratio" that purports to identify horizontal inequity. The ratio is valid only on the assumption that every variation is an inequity. The variations in tax for varying costs of living, however, are mostly mandated by equity. Wealthier taxpayers who buy greater amenities, for example, should pay greater tax. Moving over to a ratio before establishing the underlying equities being measured just obscures the debate. It is far too early to move over to the ratios.

For further reading, *see, e.g.,* Michael S. Knoll & Thomas D. Griffith, *Taxing Sunny Days: Adjusting Taxes for Regional Living Costs and Amenities*, 116 Harv. L. Rev. 987 (2003), and Louis Kaplow, *Regional Cost of Living Adjustments in Tax-Transfer Schemes*, 51 Tax L. Rev. 175 (1996).

COUNTERPOINT

The Inequities in Cost of Living Adjustments

By Joseph Dodge*

I do not understand Professors Angelini and Noga (especially in their *Tax Notes* piece of December 8, 2008) to be proposing a geography-based high-housing-cost-of-living adjustment. Their core finding is of a "wide geographical variation in horizontal equity among the states likely attributable to varying amounts of federal income tax [itemized] deductions for mortgage interest, property taxes, and state income taxes." Horizontal equity (HE) is measured by net economic income (AGI) as adjusted upward to remove various exclusions and deductions related to savings. That is, the baseline for measuring HE assumes the absence of the itemized deductions in question, two of which (mortgage interest and property taxes) are attributable to the cost (and/or value) of housing, which varies by geography, and the third of which can be described in neutral terms as a geographical cost-of-living variable. In simple English, the charge is that these itemized deductions derived from geographical cost-of-living variables produce *lower* tax for people in high-housing-cost localities than those with the same economic income in normal-cost-of-living localities. If anything, the thrust of their article calls for repeal of these deductions, because they don't really reduce what they consider to be the normative tax base, namely, ability to pay.

In any event, the fact that taxes fall unevenly according to geography is not a problem in itself. Residents of Connecticut pay higher per capita income taxes than people in Mississippi because, under a personal income tax, differences in income are supposed to matter, and residents of Connecticut have the higher per capita income. *The relevant question is whether the itemized deductions are appropriate in the first place.* If they are, then there's no problem of geographical uniformity. Suppose residents of West Virginia incur higher uninsured medical expenses than residents of Florida (and assume that income distributions are otherwise the same). If the medical expense deduction is an appropriate adjustment to the tax base, and if West Virginia residents benefit disproportionately, then there's no unfairness problem just because the tax benefits play out disproportionately according to geography. Similarly, if

* Stearns Weaver Miller Weissler Alhadeff & Sitterson Professor of Law, Florida State University College of Law, Tallahassee, FL.

the itemized deductions identified by Professors Angelini and Noga are sound, then there's no fairness problem, because the tax base is correctly measuring what it is supposed to measure. It happens that the scholarly literature is opposed to the home mortgage interest deduction, and there are commentators on both sides as to the deductibility of state and local taxes. Opponents of these deductions might be grateful to Professors Angelini and Noga for possibly providing them with further ammunition, but I doubt if anybody on the fence would be persuaded to get off of it by this study.

Another way of stating the matter is that how you construct the model pretty well determines what comes out. Professors Angelini and Noga construct a concept of the normative tax base by which to determine HE by assuming that the deductions in question should not be considered. It is predictable that regional differences in quantity of expenses that generate these non-normative deductions will show up as geographical discrimination.

However, there is a danger that talk about regional discrimination could have the opposite effect than what is intended. For example, Professors Thomas Griffith and Michael Knoll argue that regional housing-cost differences matter on economic efficiency grounds. These authors assume that a given wage in Atlanta yields a higher standard of living than the same wage in Manhattan, but at the same time this disparity might be compensated for by "amenities" unique to Manhattan. The bottom line for Professors Griffith and Knoll is that failure to make an appropriate *downward* tax adjustment discourages moves to areas where higher wages are offered either to compensate for higher living costs or to compensate for lower amenities. Thomas Griffith & Michael Knoll, *Taxing Sunny Days: Adjusting Taxes for Regional Living Costs and Amenities*, 116 Harv L. Rev. 987 (2003). Perhaps the Angelini and Noga research rebuts the high-salary/high-cost scenario in that the higher deductible costs will already provide the appropriate tax base adjustment. But then their findings will be used to support a contrary thesis to theirs, namely, that the deductions in question are at least partially justified.

In the "Point" to which I am responding, Professors Angelini and Noga appear to have moved to a position that is more open to geographical adjustments of all sorts than was proposed in their December 8 piece. Openness to downward tax adjustments for high-housing-cost localities could only be justified if living costs should be taken into account in determining HE. Otherwise, why care about cost of living? The only thing that would matter would be income (net of costs of income production). Housing costs are a prime component of personal consumption, which (in principle) is not deductible at all under an income tax. People can choose how to spend their money. The value of things to people is, according to market theory, reflected in their costs. Housing costs must be high in San Francisco because housing has a higher market value pursuant to the dynamics of supply and demand, whether by reason of location, climate, access to good schools, level of government services, access to culture, or proximity to Whole Foods. The high cost must be worth it.

The case for deducting "high" housing costs is no more persuasive than the case for allowing a deduction to one who consumes an excess of any other consumption item, such as food, alcohol, drugs, or gambling. No commentator has proposed a tax allowance for excess consumption even where it is "involuntary" (the result of addiction or psychological compulsion). No person is compelled to live in the Bay area or prohibited from moving to a low-cost area (say, Cleveland). Unlike inflation costs, excess housing costs can be avoided by moving to a cheaper location and cashing in, mostly tax-free, on the gains of any existing homes they happen to own. The economic efficiency case advanced by Griffith and Knoll is not persuasive. Wouldn't a rational employer move rather than pay higher wages to compensate either for higher costs or lack of amenities? The failure to move must be explainable either by higher profits (net of the higher wages) or a subjective locational preference.

If it is appropriate to offer a downward tax adjustment for high housing costs, then it would also be appropriate to mandate an upward tax adjustment to reflect low housing costs. Politicians, however, are loathe to inflict harm on significant groups of taxpayers. Accordingly, proposals of this sort tend to be implemented asymmetrically, that is, by only offering tax breaks without inflicting correlative tax burdens.

A tax allowance related to hypothesized higher costs essentially operates as a subsidy. Such is the case with section 911, which allows a deduction for incremental housing costs of U.S. taxpayers having foreign-source earned income. Section 911 is intended to lower the assumed psychological barrier of moving to a foreign country, and has been roundly criticized by commentators. There is no barrier (other than of the psychological sort) to moving to lower-cost U.S. locations, and there is no reason to subsidize those who choose to move to Aspen from Akron. I'm not even sure that the persons least able to move are the poor. But now we are talking about a relocation subsidy rather than a housing subsidy.

The income tax, following the ability-to-pay concept, provides allowances off the bottom for subsistence. But the case for increasing the standard deduction for residents of selected high-housing-cost localities has not been made. It is not clear that subsistence in Vallejo, California is really higher than in Newark, New Jersey. The study by Professors Angelini and Noga does not cover persons with ability-to-pay income below $40,000. Since poor and working class people are able to find housing in the vicinity of high-housing cost areas, an initial hypothesis might be that housing costs at the bottom do not vary

greatly by geography, or else that those at the bottom are sufficiently compensated either by amenities or higher wages. In addition, housing costs are not tied to current economic conditions as are (say) food costs, because housing costs (and in California, property tax costs) are set at the time of purchase (or, in the case of rent, possibly by rent control laws) as opposed to the time of consumption, and the purchase (or lease) might have been decades or generations in the past. Thus, tax return information wouldn't be adequate to identify persons who really need a subsidy. Tax allowances off the bottom would not help the really poor. Other federal and state programs exist that are designed to subsidize housing for the poor. There is no reason to assume that the poor would obtain the entire benefit of any subsidy directed at them. Any tax allowance will give such persons more money to spend on housing, and the increased demand would be expected to drive prices (rents) up, just as existing tax benefits for home ownership are considered to have driven up home prices.

The notion of location-based adjustments to the tax base is an idea whose time (fortunately) has not come.

A Response to Professors Johnson and Dodge

By James P. Angelini and Tracy Noga

We wish to thank Professors Johnson and Dodge for their thoughtful comments on our paper regarding geographic differences in horizontal tax equity. However, both professors' comments reflect common misconceptions about horizontal equity (HE).

HE is not about tax burdens or total taxes paid by taxpayers in different parts of the country. Both professors focus on the tax liability rather than the *variance* in the tax liability. HE is about each income group paying the same amount of tax, not how much tax they pay. HE does not speak to whether the tax liability is too high or too low relative to other income groups but only within an income group. We did not say we were equalizing tax burdens or "taking away variations in cost of living" or reducing taxes in high cost of living areas. We do not advocate shifting tax burdens to low cost areas, as both authors seem to imply (and spend much time discussing). In fact, our data suggest the opposite.

People in low cost areas actually pay more tax relative to taxpayers in higher cost areas that make the *same* income. We agree that taxpayers in high income areas shouldn't be subsidized. Looking at the detail for each state, our measure of HE does not systematically decrease (*i.e.*, get more equitable) with an increase in income. Both authors assume that our results suggest HE varies perfectly with cost of living variances. In fact, it does not. HE can be high (inequitable) in high cost states and low cost states. Both authors imply that HE correlates with income, which we did not demonstrate or claim. An examination of our results indicates that HE does not systematically decrease with an increase in income, as many might expect.

Both authors focus virtually solely on the housing cost variable. Our prior research, the basis for this commentary, simply establishes the magnitude of the inequity inherent in the current federal income tax system. Although we suggest housing costs as one of the many causes, our ongoing research focuses on the many variables that contribute to inequity. Admittedly, one of the largest contributors to inequity may be housing; however, there are many other variables that are potentially causal, such as AMT (loss of state and local tax deductions, miscellaneous itemized deductions and some mortgage interest deductions), marital status, number of dependents, itemizers vs. non-itemizers, state and local income taxes, and others.

For example, our research indicates that HE for a particular income group varies considerably between states for renters with no children and that HE decreases for taxpayers with children more than for those without children. The data also shows less HE for taxpayers that own houses versus those that rent. None of these results exhibit the "rich vs. poor" scenarios postulated by Professors Johnson and Dodge. Our research merely points out that there is a significant difference in HE within income groups both between and within states. We suggest possible causes but cannot demonstrate empirically any causation at this time, other than that HE does vary, which it should not in a perfectly equitable tax system.

Critiquing our HE measure (Coefficient of Variation) is a fair criticism. Trying to measure HE is difficult and researchers have struggled for years to come up with a measure, yet it remains imperfect. Nonetheless, it does not mean that we should not study nor be concerned with HE.

Both authors miss the point of our research, which for the first time demonstrates that horizontal equity, not just tax burden, varies geographically. This variation is a fundamental violation of equity principles and needs to be studied and possibly corrected, regardless of the cause of the inequity. We recommend further study into the root causes of this geographical difference as well as other causes of inequity. Depending upon the results of the future research, recommendations for tax policy changes can be made. ■

2009 Distinguished Service Award Recipient Irwin L. Treiger

By Dennis B. Drapkin*

The Section of Taxation honors Irwin L. Treiger as the 2009 recipient of its Distinguished Service Award in recognition of his outstanding career in the tax law and contributions to our profession and the Section.

Irwin L. Treiger of Seattle, Washington, is this year's recipient of the Section's Distinguished Service Award. In honoring Irwin, the Section recognizes his extraordinary professional, community service, and leadership accomplishments, and the aspirational standard he has set for all of us.

A native of Seattle, Irwin received his undergraduate and law degrees from the University of Washington, graduating from law school first in his class, and serving as a member of the Order of the Coif and editor-in-chief of the law review. He then married Betty Lou, a fourth-generation Seattle resident. Irwin was required by his draft board to turn down a judicial clerkship with Justice William O. Douglas. Instead, he opted for an LL.M. at NYU, and again was first in his class, which included Jim Eustice. He soon returned to Seattle, where he has practiced law ever since.

Irwin's legal career began at Bogle & Gates, where he practiced for over 40 years, including 12 years as managing partner and chairman. (Irwin once identified the "worst moment" in his career as "my election as managing partner of my firm (the opportunity to serve as the firm's fireplug).") In 1999, he joined Dorsey & Whitney, and this past August moved to Stoel Rives. Irwin is a business lawyer, as well as an expert in estate planning, charitable giving, and non-profits. Much of his career has been devoted to assisting small businesses, helping them grow. Irwin is valued for his wisdom, insight and dedication. He inspires loyalty from clients, who often become close personal friends, and earns the confidence and respect of those who work with him.

As the Tax Section's first Vice Chair for Professional Services, Irwin worked to change the focus of Section Meetings to CLE. He chaired the Section from 1988-1989, served as the Section's delegate to the ABA House of Delegates from 1990-1996, and was a member of the ABA Board of Governors for three years. He has also chaired the Tax Section of the Washington State Bar Association and the National Conference of Lawyers and CPAs. Irwin helped organize the ABA Tax Section's Second Invitational Conference on Income Tax Compliance, held in 1988, and chaired the Section's Public Outreach Task Force in 1999–2000. He has been a leader in addressing issues relating to lawyers practicing in a multidisciplinary setting and the practice of law by accounting firms.

This brief summary of Irwin's legal career might suggest that it consumed all of his time. That is far from accurate. Irwin has been and remains a major contributor to Seattle civic endeavors, inevitably in a leadership role and often at a critical juncture in the organization's existence. He has served as chair of the Greater Seattle Chamber of Commerce and the Seattle Foundation, as trustee of the Samis Foundation, and as a trustee of Seattle Rotary and president of the Seattle Rotary Service Foundation. During Irwin's tenure as chair of the Chamber of Commerce, Seattle hosted the first meeting of the Asian Pacific Economic Conference, which was attended by the heads of state of almost all of the Asian Pacific countries, including President Clinton. He served as head of the King County Baseball Park Commission and was instrumental in having a new stadium built, which, among many other efforts by Irwin, helped keep the Mariners baseball team in Seattle.

Irwin's service to Seattle baseball was honored when he tossed the ceremonial first pitch at Safeco Field on his 70th birthday. Irwin has worked tirelessly to help provide Seattle's major arts organizations with leadership and adequate financial support. He chaired a panel appointed by Seattle's mayor to address the Seattle Symphony's severe financial crisis in the 1980s. Most of the panel's recommendations were implemented, and the Symphony was able to avoid bankruptcy. He subsequently led the Corporate Council for the Arts of Puget Sound, the Seattle Symphony Foundation and the Cornish College of the Arts (which he also successfully helped through serious financial difficulties). Irwin has long been a leader of the Seattle Jewish community and served as president of the Jewish Federation of Greater Seattle.

Irwin's public service continues. Two years ago he agreed to head up efforts to reform the state of Washington's tax system, and he serves as chairman of the Tax Reform Steering Committee of the Puget Sound Regional Council's Prosperity Partnership. This group's tax reform recommendations are still being actively debated.

Irwin's community service has not gone unrecognized. In connection with Irwin's receiving the Benjamin Cardozo Award for Outstanding Service, Washington Governor Gary Locke proclaimed May 28, 1997, as "Irwin Treiger Day." In 1999, his law school classmate, former speaker of the House of Representatives Thomas S. Foley, presented Irwin with the University of Washington Law School's Distinguished Alumnus Award.

No article about Irwin would be complete without mentioning his beloved cigars. There he is, a phone in one hand and a very large cigar in the other, various papers spread out on his lap, his attaché case nearby, doing good for the community. One reporter described him as a "cigar-chomping, baseball-loving tax attorney." ■

* Jones Day, Dallas, TX.

CLE Calendar | www.abanet.org/tax/calendar

DATE	PROGRAM	CONTACT INFO
July 30 – August 4, 2009	ABA ANNUAL MEETING Chicago, IL	ABA Meetings and Travel **www.abanet.org/annual/2009/** | 800.285.2221
July 31, 2009	ABA DIVERSITY SUMMIT: THE NEXT STEP Hyatt Regency Chicago – Chicago, IL *Primary Sponsor: Center for Racial and Ethnic Diversity*	ABA Meetings and Travel **www.abanet.org/annual/2009/** | 800.285.2221
July 31, 2009	BUY-SELL AGREEMENTS FOR CLOSELY HELD BUSINESSES AND PROFESSIONAL PRACTICES Hyatt Regency Chicago – Chicago, IL	ABA Meetings and Travel **www.abanet.org/annual/2009/** | 800.285.2221
July 31, 2009	DUE DILIGENCE: STATE AND LOCAL TAX ISSUES AFFECTING BUSINESS ACQUISITIONS Hyatt Regency Chicago – Chicago, IL	ABA Meetings and Travel **www.abanet.org/annual/2009/** | 800.285.2221
July 31, 2009	THE FINANCIAL MELTDOWN AND ITS AFTERMATH: WHAT'S A LAWYER TO DO? Hyatt Regency Chicago – Chicago, IL *Primary Sponsor: Section of International Law*	ABA Meetings and Travel **www.abanet.org/annual/2009/** | 800.285.2221
July 31, 2009	LAWYERS' PERSONAL INVESTMENT PLANS AND RELATED TAX ISSUES Hyatt Regency Chicago – Chicago, IL *Primary Sponsor: Senior Lawyers Division*	ABA Meetings and Travel **www.abanet.org/annual/2009/** | 800.285.2221
August 1, 2009	HEALTH PLANS: THE CHANGING LANDSCAPE Swissotel – Chicago, IL *Primary Sponsor: Health Law Section*	ABA Meetings and Travel **www.abanet.org/annual/2009/** | 800.285.2221
August 1, 2009	NEW DEVELOPMENTS IN ACCOUNTING FOR EMPLOYEE BENEFIT PLAN ASSETS AND LIABILITIES Hyatt Regency Chicago – Chicago, IL	ABA Meetings and Travel **www.abanet.org/annual/2009/** | 800.285.2221
August 2, 2009	ETHICAL, PROFESSIONAL, AND TAX ASPECTS OF BACKDATING PARTNERSHIP AGREEMENTS AND PARTNER TRANSACTIONS Hyatt Regency Chicago – Chicago, IL *Cosponsor: Section of Business Law*	ABA Meetings and Travel **www.abanet.org/annual/2009/** | 800.285.2221
August 2, 2009	THE NEW ERA OF RETIREMENT PLAN INVESTMENTS Swissotel – Chicago, IL *Primary Sponsor: Health Law Section*	ABA Meetings and Travel **www.abanet.org/annual/2009/** | 800.285.2221
October 1-2, 2009	ALI-ABA COURSE OF STUDY: CONSOLIDATED TAX RETURN REGULATIONS Hilton Washington Embassy Row – Washington, DC	ALI-ABA **www.ali-aba.org** | 800-CLE-NEWS
October 19-20, 2009	20TH ANNUAL NATIONAL INSTITUTE ON HEALTH AND WELFARE BENEFIT PLANS: RESPONDING TO CHANGE The Ritz-Carlton Pentagon City – Arlington, VA	ABA JCEB **www.abanet.org/jceb** | 202.662.8641
October 26-27, 2009	24TH ANNUAL NATIONAL INSTITUTE ON COMPENSATION FOR EXECUTIVES AND DIRECTORS New York, NY	ABA JCEB **www.abanet.org/jceb** | 202.662.8676
November 16-17, 2009	19TH ANNUAL NATIONAL INSTITUTE ON ERISA LITIGATION Millennium Knickerbocker Hotel – Chicago, IL	ABA JCEB **www.abanet.org/jceb** | 202.662.8640
November 19-20, 2009	20TH ANNUAL PHILADELPHIA TAX CONFERENCE Loews Philadelphia Hotel – Philadelphia, PA	Tax Section **www.abanet.org/tax** | 202.662.8670
December 3-4, 2009	26TH ANNUAL NATIONAL INSTITUTE ON CRIMINAL TAX FRAUD Hotel Nikko – San Francisco, CA	Tax Section **www.abanet.org/cle** | 800.285.2221

Boxscore

Since January 2009, 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
Senate Finance Committee, House Ways and Means Committee	6/9/2009	n/a	Statement of Policy Regarding U.S. International Taxation	Section of Taxation	Stuart M. Lewis
Internal Revenue Service	6/4/2009	6694, 7701	Comments on Proposed Amendments to Circular 230 Section 10.34	Standards of Tax Practice	Peter S. Wilson, Scott D. Michel
Internal Revenue Service	6/3/2009	482	Comments on Temporary Cost Sharing Agreements	Transfer Pricing	John P. Warner
U.S. Department of Labor	5/27/2009	n/a	Comments on Regulations Relating to the Exemptions for the Provision of Investment Advice Under Section 408(B)(14) and Section 408(G) of ERISA	Employee Benefits	Andrew L. Oringer, Kurt L.P. Lawson
United States Tax Court	5/27/2009	n/a	Proposed Amendments to the Rules of the United States Tax Court	Court Procedure and Practice	Christopher S. Rizek
Internal Revenue Service	5/5/2009	108(i)	Comments on the Application of Section 108(i) to Partnerships and Partners	Partnerships and LLCs	Matthew Lay
Internal Revenue Service	5/4/2009	108(e)(8)	Comments on Proposed Regulations Under Section 108(e)(8)	Partnerships and LLCs	Karen Lohnes
Senate Finance Committee, House Ways and Means Committee	4/30/2009	n/a	Joint Statement on Tax Issues in Health Care Reform	Sections of Taxation and Health Law	Stuart M. Lewis
Internal Revenue Service	4/27/2009	460	Comments Concerning Proposed Regulations Under Section 460	Real Estate	Jon G. Finkelstein
Internal Revenue Service	4/22/2009	856(c)(4)(A)	Request for Guidance on the Treatment of Interests in Money Market Mutual Funds Under Section 856(c)(4)(A)	Real Estate	Thayne Needles, James Sowell
House Ways and Means Committee, Senate Finance Committee	4/21/2009	6662A, 6707, 6707A, 6708	Statement of Policy Favoring Reform of Federal Civil Tax Penalties	Section of Taxation	Armando Gomez
House Appropriations Subcommittee on Financial Services and General Government, Senate Appropriations Subcommittee on Financial Services and General Government	4/14/2009	n/a	Letter Regarding Need to Ensure Adequate Funding for Internal Revenue Service	Section of Taxation	William J. Wilkins
Internal Revenue Service	2/4/2009	108	Comments on Proposed Regulations Under Section 108 Concerning Reduction of S Corporation Tax Attributes	S Corporations	Kevin D. Anderson
Internal Revenue Service	1/5/2009	816(a), 831(c)	Comments Concerning Notice 2008-19 and Segregated Arrangements That Do Not Involve Insurance	Partnerships and LLCs	Thomas E. Yearout

*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.

ABA SECTION OF TAXATION PUBLICATIONS:

The Tax Lawyer (TAXL)

ABA CLEs (ABATAX-CLE)

ABA Section of Taxation Comments to the U.S. Congress, Federal Agencies and Tax Court (ABA-FTXCOM)

Guide to Nonprofit Corporate Governance in the Wake of Sarbanes-Oxley (ABA-NCORPGOV)

State and Local Tax Lawyer (SLTAXL)

The Property Tax Deskbook (ABA-PTD)

A Comprehensive Analysis of Current Consumption Tax Proposals (ABA-CONSTAX)

Value Added Tax: A Model Statute and Commentary (ABA-VALADTAX)

Sales and Use Tax Deskbook (ABA-SUTX)

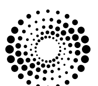
Now available on Westlaw®.

For information please call **1-800-207-9378.**

West, a Thomson Reuters business is a new primary sponsor of the ABA Section of Taxation.

BETTER RESULTS FASTER.

Westlaw®


THOMSON REUTERS™

© 2009 Thomson Reuters L-346713/2-09
Thomson Reuters and the Kinesis logo are trademarks of Thomson Reuters.

American Bar Association
Section of Taxation
740 15th Street, NW
Washington, DC 20005
www.abanet.org/tax

NON-PROFIT ORG.
U.S. POSTAGE
PAID
PERMIT #8118
WASHINGTON, DC

NEWS BRIEFS *continued from page 18*

Call for VITA Volunteers

The IRS Volunteer Income Tax Assistance (VITA) nationwide programs provide free assistance to low-income, elderly, disabled, and other individuals who require assistance in preparing their tax returns and who, now more than ever, cannot afford the services of a paid professional tax preparer. The program is an excellent pro bono opportunity for Tax Section members who want to dedicate their time. For information on how and where to volunteer, please contact Catherine B. Engell at engellc@staff.abanet.org.

State and Local Tax Lawyer Symposium Editions—Now Available

The *State and Local Tax Lawyer—Symposium Edition* explores current issues and trends in the evolving area of state and local taxation. This annual, peer-reviewed journal features papers presented by leading law professors and practitioners at the annual State and Local Tax Symposium cosponsored with Georgetown University Law Center. Recent topics include:

- SALT and Tax Shelters – Policy, Practices, and Problems (2006 – available)
- The Commerce Clause and State Taxation (2007 – available)
- The Story Behind Combined Reporting (2008 – forthcoming)
- Multijurisdictonal Enterprises (2009 – forthcoming)

The 2006 and 2007 Editions are available at a discounted price of $75 for Tax Section members. For more information, go to www.abanet.org/tax/pubs.