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PRO BONO MATTERS

Still Fighting the War on Poverty

By Francine J. Lipman*

> "If a free society cannot help the many who are poor, it cannot save the few who are rich."—John F. Kennedy

Almost fifty years ago, President Lyndon B. Johnson declared war on poverty and wisely appointed Sargent Shriver as his top general. Sargent Shriver, a Yale Law School graduate and attorney, walked, talked, lived, and breathed a rich full life committed to public service. Sargent Shriver founded the Peace Corps, Jobs Corps, VISTA, Head Start, Community Action, Upward Bound, Legal Services, and Office of Economic Opportunity and was active in the Special Olympics, which his life partner, Eunice Kennedy Shriver, founded in their backyard in the early 1960s.

Despite Shriver's landmark accomplishments, idealism, incredible energy, and talent, America did not win its war on poverty before he passed away in early 2011. Shortly before his death, the nation's poverty rate rose to more than 15%, its highest level since 1993. More than 46 million people live in poverty in America, 2.6 million more than in 2010. Tragically, 21% of children nationwide live in poor families. While these statistics are heart wrenching, financial insecurity is actually more pervasive than these numbers portray. A recent study from Wider Opportunities for Women finds that 45% of all Americans (55% of all children) live in households that lack economic security, "defined as the ability to pay for basic needs like food, transportation and medical care, while setting aside a modest amount of money for emergency and retirement savings." The majority of American children are living in or on the precipice of poverty.

Fortunately, Sargent Shriver's legacy lives on in the countless everyday heroes who practice his guiding principles—opportunity, responsibility, community, and empowerment. Katie Tolliver Jones, one of the 2010–2012 Public Service Fellows, practices these principles on the front line against pernicious poverty in rural Appalachia. A 2010 law graduate, Katie practices tax law in eastern Tennessee—where almost one out of every four children lives in poverty. Tennessee is home to 336,453 children living in poor families and each one suffers the daily hardship of living without basic necessities. Statistics do not begin to tell the story of what it means to a mother when her children do not have shoes to wear or enough food to eat; when the electricity is shut off for nonpayment and the well water is not safe to drink. Katie sees the pain in the faces of her clients who not only suffer without basic necessities, but also lack fundamental rights—including access to justice.

Standing on the shoulders of heroes like Sargent Shriver, Katie is making a difference in the everyday lives of her clients and their families by working through the tax system to break the cancerous cycle of poverty. One pro bono matter at a

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FROM THE CHAIR

By William M. Paul*

In my last column I discussed professionalism and the pressures created by the emphasis on profits in the current law firm business model. The column focused on the importance of maintaining high ethical standards in advising clients as part of a tax lawyer's obligations to the integrity of the tax system.

Now I'd like to turn to a second aspect of professionalism that is strained in the current environment: our responsibility as tax professionals to provide pro bono legal services to persons who cannot afford to pay for adequate legal assistance. Just as the "business of law" puts pressures on the traditional concept of professionalism in advising paying clients, it can also tend to squeeze out time for pro bono activities.

I have been fortunate to spend my entire career as a practitioner with a law firm that has a long-standing and continuing commitment to pro bono. That was one of the reasons I joined the firm back in 1978. In my years as an associate, I was able (among other things) to work for six months at a Neighborhood Legal Services office in D.C. as part of a continuing rotation of firm associates through those offices. In later years, I had the honor of serving for a time as chair of the firm's Pro Bono Committee.

Not all firms have this culture or tradition. Even in firms that may have historically placed a high value on pro bono activities, firm management may now view lawyer time spent on pro bono as a non-productive activity that can no longer be subsidized by paying work. The increased "efficiency" of the market for legal talent, and the corresponding emphasis on profitability, have made that subsidy harder to sustain.

One business pressure that pushes the other way, at least historically, has been the need for law firms to recruit talented law school graduates, many of whom have a keen interest in going to a firm that places a high value on pro bono. I say "at least historically" because I worry that this pattern is less true today than it was 10 or 20 years ago. The fact that many law school graduates start their careers burdened with large debts from financing their education may cause these graduates to focus more on the bottom line. In addition, the compensation of lawyers at major firms has increased so dramatically in the past ten years that the practice of law may now appeal more to those who simply wish to make a lot of money and have little or no interest in the public citizen aspect of practicing law. The depressed job market for law graduates in the last few years may also have had an impact.

Preserving a robust commitment to pro bono—or building the commitment where it doesn't exist—requires a continuing and multi-prong effect. Firm management must be persuaded that it is part of the firm's professional obligations. Practitioners need to be willing to make time for pro bono amid the increased demands of practice. Senior lawyers need to make clear that spending time on pro bono matters is an important part of professional life.

I think we can rightfully take pride in the fact that the Tax Section is doing its part in supporting and facilitating the provision of pro bono legal services to taxpayers. The range of pro bono-related activities of the Section and its members is remarkable. Here are just a few of the highlights:

- **Low-income taxpayer clinics.** The Tax Section has a great history of supporting low-income taxpayer clinics across the country. The Section recently published the 5th Edition of *Effectively Representing Your Client Before the IRS*, and the Section is providing free copies to all of the roughly 160 low-income taxpayer clinics that receive grants from the IRS. Some 60 members of the Tax Section volunteered their time to prepare the new edition. Originally developed as a handbook for clinics, this treatise is actually a useful resource for all practitioners.
- **VITA and Military VITA.** The Section supports the IRS's Volunteer Income Tax Assistance (VITA) program and many Section members participate. Through VITA, practitioners as well as law students provide free tax return preparation for low-income, elderly, disabled, and other individuals. Section members also participate in the Military VITA program by training others to prepare returns for service personnel on military bases.
- **Tax Court Calendar Call Programs.** There are currently 11 Tax Court Calendar Call Programs across the country. These programs have all been started by Tax Section members working with state and local bar associations. Volunteers attend the Calendar Call and provide assistance to pro se petitioners. The Tax Court is very appreciative of these programs.

These are just a few of the pro bono-related activities supported by the Tax Section and Tax Section members. Another important program is the awarding of Public Service Fellowships. I encourage you to read the inspiring report on one of the Section's current Public Service Fellows in the Pro Bono Matters column in this issue. More information about the Section's pro bono activities is available on the Section's website at www.americanbar.org/groups/taxation/resources/tax_pro_bono.

If you'd like to pitch in and aren't sure how to go about it, here are some ideas: take overflow cases from a low-income tax clinic, participate in a Calendar Call Program or help organize one in your area, get involved in VITA or Military VITA. If you'd like some guidance on how to get involved in any of these activities—or would like to find some other way to get involved in pro bono—contact Rachel Ney, the Section's full-time pro bono staff counsel, at Rachel.Ney@americanbar.org. ■

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INTERVIEW

Douglas L. Lindholm

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

Douglas L. Lindholm is President and Executive Director of the Council On State Taxation (COST). He previously served as Counsel, State Tax Policy for the General Electric Company and worked in the Washington National Tax Services Office of Price Waterhouse LLP.

Q Please describe the history and activities of COST.

A This is COST's 42nd year—we were originally formed as the Committee on State Taxation in 1969 as part of the Council of State Chambers of Commerce, and today we count nearly 600 of the nation's largest corporations as our members. Our mission is to preserve and promote equitable and non-discriminatory state and local taxation of multijurisdictional entities. As our name implies, we've played a central role in nearly every state tax issue affecting multistate corporate taxpayers during our 42-year history. The circumstances that led to the formation of COST had their origins well before then, however, and a little historical context on the development of the legal framework that informs state taxation as we know it today is appropriate. Back in the 1950s, most commerce was local, and most companies paid state income taxes to their headquarters state only. A typical manufacturer of tangible property would manufacture in one location and send salespeople (drummers) to other states to sell its products. The notion of the need for uniformity in state taxation was starting to percolate in legal circles, however, and in 1957 the National Conference of Commissioners on Uniform State Laws (drafters of the Uniform Commercial Code) promulgated the Uniform Division of Income for Tax Purposes Act (UDITPA), although few states adopted it. In 1959, the Supreme Court ruled in *Northwestern States Portland Cement* (358 U.S. 450 (1959)) that states could constitutionally impose an income tax on those out-of-state manufacturers based solely on the presence of traveling salespeople. Companies were thus faced with the prospect of filing income tax returns in every state where they sent salespeople. In response to that case (and denial of *cert.* in two others) business groups petitioned Congress for relief. Within six months, Congress passed Public Law 86-272, which prevented states from imposing income tax on a corporation if the only presence in the state was an employee or agent who solicited orders for tangible personal property.

During debate on the legislation, the states were aghast at the liberties Congress was taking with regard to the states' perceived sovereign right to determine their tax structures. To placate the states, Congress included in the bill a commission—dubbed the Willis Commission after its Chair Rep. Edmund Willis—to study and make recommendations on how to fix the lack of uniformity in state and local taxation of multistate corporations. For nearly five years the Willis Commission convened hearings throughout the country, heard testimony from numerous experts, and ultimately issued its report in 1965. Among the more significant recommendations was the suggestion that the U.S. Treasury Department should administer and collect all state corporate income taxes, and redistribute the revenues to the states based on an agreed-upon factor, such as population. To forestall such a perceived inequity, the states in 1965 established the Multistate Tax Commission (MTC)—with UDITPA as the centerpiece of a Multistate Tax Compact—as a way to foster voluntary uniformity in state taxation. For the next three or four years, state tax commissioners and the business community met as part of an ad hoc committee to seek a uniform apportionment method that could be supported by both groups. Those efforts ultimately fell apart for two primary reasons: the MTC's multistate corporate audit program, and the MTC's failure to secure congressional approval of the Multistate Tax Compact.

In 1969, a group of roughly 100 companies formed a coalition to support litigation against the MTC, challenging its right to conduct multistate audits, and indeed, its very existence under the Compact Clause of the U.S. Constitution. That small group of companies became known as the Committee on State Taxation, or COST, and was initially organized under the auspices of the Council of State Chambers of Commerce. The case challenging the MTC (*U.S. Steel Corp. v. Multistate Tax Commission*, 434 U.S. 452 (1978)) made its way to the Supreme Court in 1978, where the MTC's status and approach was vindicated. That case, however, set the tone for many years to follow of the adversarial relationship between COST and the MTC, some of which remains today, although certain joint projects have been undertaken with some success. In 1992 COST became separately incorporated, and in 2002 we changed our name to the Council On State Taxation. We operate under I.R.C. section 501(c)(6) as a non-profit organization.

Over the years, the COST Board made efforts to work jointly on projects with

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the MTC, but several large unresolved issues have always been in dispute: the proper standard for determining nexus, the unitary question, taxation of certain foreign source income, and the forced collection of tax on remote sales. None of these questions have yet been resolved to the satisfaction of either states or multistate taxpayers, and they largely define the relationship of the two organizations to this day.

COST today has two primary roles—advocacy and education. From a legal perspective, our primary role is to file amicus curiae briefs on state tax issues before state supreme courts and at the U.S. Supreme Court on behalf of our members, thereby providing the larger perspective of the multistate business community. COST is also very active in pursuing legislative and regulatory solutions for issues facing our members. And although a great deal of our time is spent reacting to initiatives seeking to impose unfair burdens on multistate companies, much of it is spent on efforts to improve the tax climate for corporate taxpayers, focusing on certainty, predictability, and ease of administration. As an example, we've recently been working with the ABA Tax Section on efforts to enact independent tribunals in states where such a forum is unavailable (nearly half the states). Our work has recently been successful in Texas, North Carolina, and Mississippi, and joint efforts are currently underway in Alabama, Georgia, Illinois, and Oklahoma.

COST's second role is to offer to our members a fairly substantive educational program. We offer basic, intermediate, and advanced instruction at our state and local tax (SALT) schools, plus three or four annual conferences focused on current developments and networking opportunities. Many of the instructors at our schools and conferences are drawn from the ABA's state and local tax committee. We also sponsor 20 to 30 regional meetings per year across the country for our members, with a mix of local and national speakers. Finally, we prepare a number of authoritative and well-respected studies on discrete state tax issues, partnering with leading economists from academia and the private sector. We've prepared studies on combined reporting, competitiveness of state tax systems, gross receipts taxes, sales taxes on business inputs, property tax administration, and unclaimed property administration. The capstone of this effort is our annual Business Tax Burden Study, prepared by economists at Ernst & Young, which is widely consulted by legislators, legislative staff, and other policymakers in the state tax arena.

Q What do you view as the most important trends in state taxation for multistate corporations today?

A Almost every trend in the state tax arena today stems from the natural tension between the parochial interests of state and local policymakers and the need to consistently ensure the free flow of interstate commerce. Every state legislator and state tax administrator is elected or appointed to look after the specific interests of their state or local jurisdiction. Often these interests are not consistent or cognizant of the need for a national common market, and much of the litigation we see arises under the Commerce Clause of the U.S. Constitution. For example, the question of what the nexus standard is for state corporate income taxes is one of those issues, and is probably the most pressing issue companies face today. It is also quite common for state legislators, seeking to raise revenues without political costs, to try to export part of the state tax burden to out-of-state companies—often in a discriminatory manner. Taxation of foreign income is another such issue, and determining whether certain income is business income (apportionable) or non-business income (allocable to a specific jurisdiction) is yet another. Also, the collection of sales tax on remote sales—another aspect of the nexus question—has been the topic of a lot of litigation and legislation recently.

Q Are those Internet sales?

A Remote sales can be either Internet sales or catalog sales—*i.e.*, any interstate sale that takes place when the company selling the product has no physical presence in the state in which the sale is made. The Supreme Court has found that in the sales tax context, no physical presence means no nexus (i.e., jurisdiction to tax), but that question remains unresolved for corporate income and other business activity taxes. For sales taxes, the nexus question is evolving into what constitutes a "physical presence" under the Supreme Court's 1992 ruling (*Quill v. North Dakota*), and is now focusing more on the nature and quality of affiliate or agency relationships with third parties in the taxing state.

Q What about uniformity in state tax laws? Are states making any effort to impose uniform laws in order to minimize burdens on multistate companies?

A I mentioned earlier that the Multistate Tax Commission was formed to foster uniformity in state tax laws. The second reason for its formation, however, was to forestall any further federal intervention in the state tax arena after enactment of Public Law 86-272. Unfortunately, those two goals tend to be self-defeating: the MTC develops and submits model statutes and regulations for consideration by its member states. Adoption of those uniform proposals, however, is on a completely voluntary basis, and because dollars (revenues) are involved, state legislatures feel no compunction against modifying or amending such proposals for their own ends. Thus the need for uniformity often takes a back seat to states' parochial interests. When one considers that the MTC only has 21 full member states to begin with, their ambition of achieving any type of voluntary uniformity is quite elusive. The business community there-

fore has come to the conclusion that the only way to achieve true uniformity in state tax laws is to seek federal legislative relief through Congress, which has plenary authority to deal with interstate commerce under the Commerce Clause. Of course, as noted, that approach is in direct conflict with the MTC's second reason for its existence—preventing such federal intervention. As a result, COST and the MTC are often at loggerheads on the uniformity question. A further complication arises because state tax issues have no real constituency before Congress. State tax issues are often so complex that congressional staffers and their bosses tend to consult their home state tax commissioners for advice on federal legislative proposals dealing with state taxes, yet as I noted earlier, the state tax commissioner's job is to focus on the specific interests of the state he or she serves, and not necessarily on the benefits of ensuring the free flow of commerce in a common market.

Q One of COST's activities you mentioned is filing amicus briefs in state tax cases. What kind of cases does COST typically weigh in on?

A Most of the cases we file in are consistent with the issues that we've been discussing. One of the advantages of COST is that the issues we see are typically of first impression, arising out of state audit assessments. We often follow developing issues through audits, administrative appeals, multiple levels of court challenges, and finally legislation, if necessary. Over the past year we've filed more than a dozen amicus briefs before state supreme courts as well as the U.S. Supreme Court. Some of the issues we've filed on recently are retroactive legislation; forced combination standards; a California case subjecting intangibles to property taxation; whether the MTC should allow a three-factor apportionment election; the appropriate judicial deference to a non-independent tribunal; the constitutionality of a "throw-out" rule; and the constitutionality of an economic presence nexus standard. As states have become more aggressive, this is clearly an advocacy function we're devoting more and more resources toward. At the beginning of the decade, we would typically file only five or six amicus briefs per year.

Q Your organization is made up of over 600 multistate corporations. Most if not all of them have in-house state tax experts. What do you see as the role of and opportunities for independent counsel in the state tax area?

A I think there are tremendous opportunities for independent outside counsel in the state tax arena. Most of our firms hire outside counsel regularly, for both multistate issues and state specific issues, and for the state tax impact on several practice areas including litigation, planning, compliance, and transactional work. There are numerous instances where companies actually would like to see more litigation because two problems tend to recur: first, litigation is often pursued in a state without appropriate consideration of its impact on other states, and second, because some of the state tax dollars tend to be small, companies will tend to settle those cases instead of pursuing the principle at the heart of the litigation. And in many cases if a company settles an issue based on an assessment of dollars at risk, it tends to embolden the state in its efforts to pursue the same issue against other taxpayers.

Q How would you rank state and local taxation among the factors that influence a multistate corporation's decisions on where to locate a business unit in a state? Has COST done any surveys on the question?

A When a company makes a decision to expand or relocate, it typically undertakes a two-step process. The first step is usually a static phase, where the company weighs all the costs of expanding and/or relocating in a number of jurisdictions. Those costs include infrastructure costs, personnel costs, access to markets, access to communications, availability of trained labor, etc., and the tax burden calculation is just one of those static costs. The taxpayer will then narrow it down to the top few locations where total costs are relatively equal. The finalist jurisdictions will be notified that they are under consideration as a finalist in the relocation decision, and are given the opportunity to seal the deal, which is typically done through targeted tax incentives or other tax considerations. So although in the initial phase the business tax burden is just one of several factors considered as part of the overall costs, in the final dynamic phase tax considerations can be the deciding factor. In my view, states should approach this process in much the same way a business would, by considering two factors: First, "clawbacks" of incentives should be a part of the package for nonperformance, say, on promises to bring a certain amount of jobs or investment to the state in return for the incentives; and second, states should be careful not to give too much of an advantage to new companies coming in, to the detriment of companies already in the state that might as a result seek to expand elsewhere in the future.

Q What sorts of competitive tax tools do states use?

A Perhaps the most effective tool available to states is to apportion corporate income for tax purposes based on a single sales factor instead of using the traditional three-factor formula of property, payroll, and sales. Apportioning income by sales allows states to effectively export their tax burden while at the same time it encourages—or at least avoids penalizing—in-state investments of capital (property) and labor (payroll). As a result, there's a distinct trend today of states moving toward single sales factor apportionment. While this may benefit state parochial interests, however, it raises some troubling questions about uniformity and the long-term burdens and viability of our state corporate income tax system. States are essentially using an apportionment concept—which

in theory is designed to equally spread income tax burdens among states—as an economic development tool which by its very nature seeks to differentiate one state from other states. It also begs the question of whether measuring a corporation's tax presence in a state by sales alone might ultimately be distortive under the Commerce Clause and therefore subject to constitutional challenge in certain fact patterns. As more and more states apportion using a single factor, I think this is an area where we may eventually see more frequent litigation.

Q What do you foresee in terms of federal legislation on state tax issues of national impact, such as taxation of interstate commerce, taxation of Internet sales, and the like?

A Let's talk about three issues—the first one is the as-yet-unanswered nexus question: what type of presence must a company have in a state before that state can compel it to pay state corporate income taxes? We have the largest, strongest, and most advanced economy in the world, yet companies operating here still do not know what the nexus standard is for corporate income and other business activity taxes. That lack of certainty and predictability in our state tax system is somewhat embarrassing, and we need to resolve that issue. The Supreme Court has clearly signaled that this is an issue that Congress is better suited to resolve, and legislation is pending before Congress on the issue. The legislation is called BATSA—the Business Activity Tax Simplification Act, and it would impose a single uniform nexus standard for all states based on physical presence, which is similar to the international standard.

The nexus question is also still an issue for sales tax, but on a different level. As I mentioned earlier, in 1992 in the *Quill* case the Supreme Court held that a state can only compel a remote seller to collect sales taxes on sales into a state if that seller has an actual physical presence in the state. The holding, based on the Commerce Clause, recognized that compliance with the existing system created undue burdens on interstate commerce. Over the last decade, COST and the business community have been supportive of state efforts to streamline state sales tax systems in an effort to reduce the burden on remote sellers enough to allow states to compel collection of sales tax on remote sales. Several pieces of legislation are now pending before Congress that would allow states to impose a collection duty if minimum simplification requirements are met. The primary legislative vehicle is called the Main Street Fairness Act, and is sponsored by Senator Durbin in the Senate and Representative Conyers in the House.

The third issue I'd like to talk about is a classic case where federal intervention is necessary from a practical standpoint. It is called the Mobile Workforce State Income Tax Simplification Act, and it is sponsored by Representatives Howard Coble from North Carolina and Hank Johnson from Georgia. Under our existing system, if employees travel for work to another state, in roughly half of the states they incur an income tax liability as of the first day they visit, and their company incurs a corresponding requirement to withhold taxes for that state from the employee's wages. The remaining states have a hodgepodge of rules, some based on days, some based on dollars. It's a very difficult set of rules to comply with. And with the current emphasis under Sarbanes–Oxley on complete compliance with all aspects of federal and state tax laws, it is putting pressure on companies to comply for thousands of traveling employees as best they can. The legislation would impose a simple 30-day threshold before state rules kick in for both employee liability and for employer withholding. Until the 30-day threshold is reached, the employer withholding and employee liability continue in the state of residency.

Q Now when you ask Congress to take a position in resolving some of these thorny areas, do you run into the fact that they have local representation themselves and every Congressman is from a district whose tax office may oppose the bill?

A We have, although I must say, given the amount of federal legislation dealing with state taxes, awareness of the problem on a national scale has gotten much better. Frankly, part of our mission is to help educate legislators about the systemic impact of disparate state actions on our economy. And because Congress has plenary authority over interstate commerce, most policymakers recognize that responsibility. We have been working on some of these issues for ten to fifteen years. The education process is often long and cumbersome, but we hope it will eventually pay dividends by improving our state tax system.

Q Do you see rising interest among your members in unclaimed property audits, and how does that affect the tax function?

A Unclaimed property is becoming a great concern for large companies because certain states are pursuing it as a major revenue source. Responsibility for unclaimed property compliance often falls within corporate tax departments because they are familiar with state audit procedures. Within the last decade or so, states have contracted with third party contingent fee auditors to pursue unclaimed property, and they've been very aggressive—using a combination of statistical sampling, no statute of limitations, and no appeal procedures for escheat challenges to levy very large assessments. Delaware, in particular, has become very aggressive because so many companies are incorporated in the state. I believe unclaimed property collections are the third largest general fund revenue source for the state of Delaware—which means, of course, that very little of what they get in the door is ever returned to the rightful owner,

raising the question of whether the "property" escheated was actually ever unclaimed in the first place. We have been pursuing corrective legislation in Delaware to ameliorate some of these perceived injustices, including a bill last year that provides an appeal mechanism for unclaimed property claims.

Q Do you see states reacting to increased pressure for revenues by making harsher rulings on their favorite tax subjects—out-of-state corporations—and what ought to be done about it?

A There is no question that states are being more aggressive against out-of-state corporations, in both legal rulings and in audits. The difficulty, of course, is that the more a state seeks to export its tax burden by targeting out-of-state corporations, the more likely it is to result in double taxation. Fortunately, most judges still take a dim view of double or multiple taxation under the Commerce Clause. Part of the problem, in my view, is that judges not well-trained in the finer points of multistate tax law tend to give the fiscal impact of their decision more weight than is appropriate. Fortunately, more and more states are realizing that establishing an independent tax tribunal with judges trained in state tax law is a best practice from a business climate and economic development perspective. As I mentioned earlier, within the last few years a number of states—including Texas, Mississippi, and North Carolina—have enacted independent tax tribunals and a number of additional states (Alabama, Georgia, Illinois, and Oklahoma) are giving the issue serious consideration in their respective legislatures.

Q How does COST interact with the states from an advocacy perspective?

A We closely monitor and participate in the work product of both the Federation of Tax Administrators (FTA) and the Multistate Tax Commission. The FTA typically focuses on procedural issues such as E-filing, electronic payment protocols, and electronic recordkeeping requirements. The MTC tends to focus more on policy oriented issues. And although we often disagree with the direction and substance of much of the MTC's proposed statutes and regulations, on occasion we are able to agree on a solution beneficial to both states and taxpayers. We also evaluate state statutory and procedural frameworks using three "Scorecards"—one deals with procedural issues and state tax appeal systems, one evaluates the statutory framework surrounding unclaimed property, and the third evaluates state administrative procedures for property taxes. All three are available on our website, at www.cost.org. These Scorecards have generally been very effective because they let state legislators see how they compare with neighboring states and specify changes necessary to improve the state's business climate.

Q Do you interact with other private organizations?

A COST was formed originally as the Committee on State Taxation under the Council of State Chambers of Commerce, a group consisting of the chief executive of each state chamber. It is a group we remain in close contact with today because they act as our primary partners in every state where we pursue legislative or regulatory advocacy. We value that relationship highly, and our organization and the Chambers have a natural symbiosis in working together on state tax issues affecting large corporations. And it works well because of the significant overlap in our membership as compared to the membership of state chambers of commerce.

Q Was there a time when you became more independent of the Chambers?

A From the start we had always been fairly independent of the Council of State Chambers because our issues were entirely multistate-tax-related and the Chamber executives had to deal with the entire panoply of business issues before state legislatures. Despite the different focus, we typically held meetings in the same location. Eventually our attendance started to dwarf the Council's (they had only 50 members), and in 1992 we officially incorporated as a different entity, a 501(c)(6) non-profit organization. It wasn't until 2002 that we officially changed our name from Committee on State Taxation to Council On State Taxation. ■

POINTS TO REMEMBER

Protecting Yourself and Your Client in a Joint Defense Arrangement*

By Rachel L. Partain†

Civil examinations and litigations and criminal cases often involve multiple, sometimes related, persons—each of whom might be represented by separate counsel. In such situations, those involved may benefit from joining together to advance their common interests or to provide for a joint defense. Ordinarily, the attorney–client privilege would not attach where a third party is present during a confidential communication between an attorney and his client, and the attorney–client privilege would be waived where formerly privileged communications are disclosed to a third party. *See, e.g., Genentech, Inc. v. United States International Trade Commission*, 122 F.3d 1409, 1415 (Fed. Cir. 1997) (citations omitted). However, as discussed further below, the common interest doctrine, also referred to as the joint defense doctrine, operates to extend the reach of the attorney–client privilege in the joint defense context.

This article highlights certain issues that should be considered by attorneys and their clients when deciding to participate in joint defense arrangements and also discusses how to formalize such arrangements.

Joint Defense Arrangements

The joint defense doctrine operates as an exception to the rule that the attorney–client privilege does not protect communications made to third parties. *See, e.g., In re Grand Jury Subpoenas, 89-3 and 89-4, John Doe 89-129*, 902 F.2d 244, 248–49 (4th Cir. 1990). In order to qualify for protection, confidential and otherwise privileged communications can be shared with joint defense participants who have a common legal interest where the communications are made in furtherance of the common legal interest. *See, e.g., United States v. BDO Seidman, LLP*, 492 F.3d 806, 815–16 (7th Cir. 2007) (citation omitted).

In addition to allowing participants to present a unified front, there are numerous benefits to forming a joint defense arrangement. The arrangements may reduce a client's expenses as participants typically share in the costs of common projects. Also, attorneys may find that participating in a joint defense group allows for an efficient use of discovery limitations, such as on the number of depositions or requests for admission, or an ability to specialize in a particular area of the joint defense. Further, joint defense arrangements can result in judicial efficiency as a result of combined court filings.

Informal or Formal Joint Defense Arrangement?

After deciding to participate in a joint defense agreement, the first issue to consider is whether to have an oral or written agreement. The answer generally depends on whether those involved trust one another. Oral agreements are often limited to situations in which the participants trust one another and the attorneys have a good working relationship. For example, an oral agreement may be appropriate in a situation in which a husband and wife retain separate counsel in connection with an investigation by the Service. Many practitioners, however, choose to use written agreements as a general rule. Formerly common interests can diverge at any point in the arrangement, particularly in the criminal context where one participant may decide to cooperate with the government. A written agreement allows for the parties to decide in advance the obligations of the participants upon withdrawal or upon the dissolution of the agreement. In fact, the joint defense agreement might require notice to the other participants as early as when a participant is in discussions with the government regarding cooperation. Further, a written agreement may help stave off a discovery demand for shared materials, given that the party asserting the joint defense privilege has the burden of proof. *See United States v. Weissman*, 195 F.3d 96, 99 (2d Cir. 1999).

Where a written joint defense agreement is used, it is necessary to determine which persons will be parties to the agreement. Should the agreement be signed only by the clients, only by the attorneys, or by both the clients and the attorneys? While it appears that nearly all practitioners have their clients sign the agreement, there does not appear to be a generally accepted practice with respect to whether the attorneys are also signatories. For the reasons discussed below, it is recommended that the agreement be between both the clients and the attorneys.

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Ethical Implications of Joint Defense Arrangements

There are potential conflicts of which attorneys should be mindful when entering into a joint defense arrangement. Some courts have found that a joint defense arrangement can create an implied attorney–client relationship. *See, e.g., United States v. Henke*, 222 F.3d 633, 637 (9th Cir. 2000). If such a relationship were found, attorneys would have ethical obligations to all participants. ABA Committee on Ethics and Professional Responsibility Formal Opinion 95-395 states that a joint defense agreement does not create an attorney–client relationship. However, an attorney that learns of confidential information from a non-client participant would have a fiduciary obligation to keep the information confidential. *See Wilson P. Abraham Constr. Corp. v. Armco Steel Corp.*, 559 F.2d 250, 253 (5th Cir. 1977). Further, as discussed in D.C. Bar Legal Ethics Committee Opinion 349, a joint defense agreement may create issues for other attorneys at the lawyer's firm unless certain precautions are taken in a timely manner.

Even a fiduciary confidentiality obligation may result in a potential conflict with respect to the joint defense matter and with respect to future matters. With respect to the current matter, under ABA Model Rule 1.7, a concurrent conflict of interest may exist where there is a significant risk that a lawyer's representation may be materially limited as a result of the lawyer's responsibilities to a third person. An attorney may be required to withdraw from the representation of his client if the attorney's ability to continue representation is limited by confidential information learned from a non-client participant. Thus, where the participants share confidences and a participant later withdraws, the attorneys may try to disqualify the attorney for the withdrawing participant, or the withdrawing attorney may try to disqualify the other attorneys based on the confidentiality obligation. With respect to future matters, an attorney may be disqualified from taking a matter adverse to a quasi-client in a subsequent, but substantially related, matter where the attorney learns confidential information from a quasi-client during the joint defense arrangement. *See Wilson P. Abraham Constr. Corp.*, 559 F.2d at 253.

Joint defense agreements containing certain key provisions that are signed by all attorneys and clients may provide some protection from the ethical concerns discussed above, although such provisions are not necessarily determinative. First, the agreement should confirm that the attorneys explained the agreement to their clients and fully advised the clients of the risks and benefits of entering into the joint defense agreement. Second, the attorneys can disclaim the creation of any attorney–client relationship in the agreement, and the attorneys can have each participant specifically confirm that he understands that no attorney–client relationship is being formed with any other attorney. In addition to the agreement itself, attorneys may want to exclude clients from joint defense meetings, as is typically the case, in order to serve as an additional protection against the finding of the creation of an implied attorney–client relationship.

Third, the agreement should address the continued representation of the remaining participants should another participant withdraw. Attorneys should consider whether to include a general provision wherein clients waive, with respect to the present or any future matters, any conflicts of any attorney who receives confidential information during the joint defense arrangement. A specific provision waiving any confidentiality obligations to a withdrawing participant is sometimes included. For example, the agreement could provide that should a participant become a cooperating witness, an attorney can cross examine or impeach the witness based on information that the witness disclosed during the joint defense. *See United States v. Stepney*, 246 F. Supp. 2d 1069, 1085–86 (N.D. Cal. 2003). Finally, some thought should be given as to whether to include specific provisions addressing conflict issues relating to the law firms of the participating attorneys.

As a final practice point, attorneys should sign the joint defense agreement individually. D.C. Bar Legal Ethics Committee Opinion 349 cautions that a law firm could potentially have obligations to non-client participants under the terms of a joint defense agreement.

Participant Concerns

Clients also may have concerns that should be addressed in the joint defense agreement, particularly relating to withdrawal. Advance planning may alleviate some of the strife that may result from the withdrawal of a member. For example, written joint defense agreements typically include a provision requiring the return of any documents or materials shared between the participants. Participants should also consider the impact that a withdrawing participant might have on any discovery methods chosen to assist with the joint defense. For example, if one participant pushes the adoption of an expensive or proprietary software program or electronic database, what happens should that participant withdraw?

Further, the parties should contemplate whether a participant can be forced to leave the joint defense group if, for example, material terms of the agreement are breached. As a significant benefit of participating in a joint defense agreement is the potential to reduce costs, the parties may want to have a process available where a member is free riding off of the group.

Conclusion

Joint defense arrangements are common given the numerous advantages of coordinating a unified strategy, but they do pose their own risks. Attorneys and their clients should reflect, prior to entering into a joint defense group, on the possible pitfalls that might occur with respect to the particular engagement and try to address such contingencies in a written agreement signed by all of the parties. ■

The New Voluntary Classification Settlement Program

By Robb A. Longman*

The Service has recently increased its employment tax audits by focusing on businesses to ensure they are properly classifying their workers. Many businesses classify workers as independent contractors when they are, in fact, employees. The distinction between the two is not always clear, but the primary factor used to determine if workers are employees or independent contractors focuses on the amount of control the employer exercises over its workers. The difference for the employer typically equals thousands of dollars saved as it does not have to pay employment taxes; however, many employers do this at a great risk because in many cases workers are misclassified as independent contractors.

The Service will always prefer to collect employment taxes from employers as it simplifies the collection process. In order to bring more taxpayers into compliance, the Service, in September 2011, released Announcement 2011-64. It provides a voluntary settlement program for employers that have misclassified their employees or others as independent contractors or nonemployees. The Voluntary Classification Settlement Program (VCSP) offers employers a significantly reduced penalty and audit protection for previous years, in exchange for their agreement to prospectively treat any and all misclassified workers as employees; in turn, it provides the Service an opportunity to bring many employers into compliance and make them responsible for withholding taxes.

Worker classification determines if an individual providing services for a business is an employee or independent contractor. The purpose of worker classification is to properly classify compensation for services rendered.

Worker classification has important federal and state tax consequences. For statutory employees, employers are responsible for withholding and paying income and employment taxes (FICA and FUTA, respectively) on wages paid to employees. An employer is required to withhold employment taxes from the employees' wages, and failure to do so can result in liability for unpaid withholding, FICA, and FUTA taxes, as well as interest and possibly personal assessment. If a worker is classified as an independent contractor, the worker is responsible for the payment of taxes on his or her earnings.

The VCSP allows employers currently treating workers (or a class or group of workers) as independent contractors to acknowledge the misclassification and convert their employees' status to that of statutory employees going forward. Employers who take this step suffer minimal adverse consequences from the Service. The requirements of VCSP are as follows:

1. The employer must have treated its workers as nonemployees, and filed all required information returns for its workers, such as Forms 1099, for the three preceding calendar years. An employer qualifies whether or not the misclassification was the result of a close call in judgment or an obvious misinterpretation of the law. The Service will not pursue businesses if they attempt to come into voluntary compliance.
2. The employer cannot currently be under audit by the Service or Department of Labor (DOL) for worker classification. An employer previously audited by the Service or DOL concerning worker classification may request to participate in the VCSP if the employer has complied with the results of the previous audit. If the employer has not complied with the requirements placed upon it by the prior audit, it will be excluded.
3. The employer must extend the period of limitations on assessment of employment taxes for three years to include the first, second, and third calendar years following the date on which the employer agrees to begin treating workers as employees. In most cases, this is an inconsequential concession; however, some employers may be concerned that the Service requires an extension of the statute of limitations on assessment.
4. The employer must request to participate in the VCSP by filing Form 8952, Application for Voluntary Classification Settlement Program. The Service has advised employers to file Form 8952 at least 60 days before the employer wants to begin treating its workers as employees.
5. Employers must apply to the Service for acceptance to the program. If the Service does not accept the employer based upon the initial Form 8952 filing, the employer may re-file. Employers should be aware of, and carefully follow, the filing rules to increase the likelihood that their filings will be accepted.

In exchange for employers' agreement to prospectively treat workers as employees, employers will only have to pay (i) ten percent of the employment tax liability that may have been due on compensation paid to workers in the most recent year and (ii) twenty percent of employee social security taxes for the immediate past year. Employers will *not* be assessed any interest and penalties on the liabilities, and they will not be subject to an employment tax audit regarding the worker classification for

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prior years. When the employer is accepted into the program, it will be required to enter a closing agreement with the Service.

Because this is a new program, questions still remain about its process and whether or not states will also provide taxpayers with a discount to come into compliance. Deals such as this, however, are not generally seen from the Service. Employers should act promptly while the opportunity is still available. ■

Recent Developments Affecting Employee Benefit Plans

By David Pratt*

As usual in the ever-changing world of employee benefits, there have been far more recent events than can be covered in this column, even briefly. The following is a brief discussion of some of the more important.

Legislation

On October 21, 2011, the President signed the Trade Adjustment Assistance Extension Act of 2011, Pub. L. No. 122-40. The Act extends the health care tax credit under Code section 35 and amends ERISA section 602 and Code section 4980(f) to extend the duration of COBRA benefits for certain TAA-eligible individuals and individuals receiving payments from the Pension Benefit Guaranty Corporation (PBGC).

Agency Action

Health Care Reform. The agencies have issued voluminous guidance on various provisions of the 2010 legislation. The best single source is the Department of Labor's (DOL) Affordable Care Act page, www.dol.gov/ebsa/healthreform/. Recent guidance includes:

- A Department of Health and Human Services (HHS) final rule on Medical Loss Ratio requirements for issuers;
- A DOL proposed rule, Summary of Benefits and Coverage and the Uniform Glossary, 76 Fed. Reg. 52442 (Aug. 22, 2011);
- An IRS, DOL, and HHS amendment to the interim final rule relating to internal claims and appeals and external review processes, 76 Fed. Reg. 37208 (June 24, 2011); and
- An IRS, DOL, and HHS amendment to the interim final rule relating to coverage of preventive services, 76 Fed. Reg. 46621 (Aug. 3, 2011).

Definition of Fiduciary. In October 2010, DOL issued a controversial proposed regulation (75 Fed. Reg. 65263) that would have expanded the definition of who is a fiduciary under ERISA. In September 2011, DOL said that it will re-propose the regulation. According to DOL, "The decision to re-propose is in part a response to requests from the public, including members of Congress, that the agency allow an opportunity for more input on the rule." The full text appears at www.dol.gov/ebsa/newsroom/2011/11-1382-NAT.html.

Investment Advice. A statutory prohibited transaction exemption enacted in 2006 allows a fiduciary, who provides investment advice to plan participants, to receive compensation if (1) the investment advice is based on a computer model or (2) the adviser's fees do not vary based on the investments selected by the participant. In October 2011, DOL issued a final regulation (76 Fed. Reg. 66136), effective for transactions on or after December 27, 2011. The final regulation provides detailed guidance on compliance with these rules.

Fee Disclosures. In 2010, DOL issued (1) an interim final regulation requiring certain retirement plan service providers to disclose information about fees and potential conflicts of interest to plan sponsors (75 Fed. Reg. 41600) and (2) a final regulation requiring plan sponsors to disclose information about plan and investment costs to participants (75 Fed. Reg. 64910). Under final regulations issued on July 19, 2011 (76 Fed. Reg. 42539), the deadline for

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complying with these regulations was extended. Service providers must provide fee disclosures to plan fiduciaries by April 1, 2012, and calendar year plans must provide fee disclosures to participants by May 31, 2012.

Hybrid Pension Plans. In Notice 2011-85, 2011-44 I.R.B. 605, the Service postponed the effective date for certain final regulations governing cash balance and other hybrid plans, extended the deadline for adopting certain hybrid plan amendments, and formalized the special timing rule for ERISA section 204(h) notices [*see* Announcement 2009-82, 2009-2 C.B. 720]. On October 31, 2011, PBGC issued proposed rules (76 Fed. Reg. 67105) for valuing benefits under a terminating cash balance plan.

2012 Cost-of-Living Adjustments. In News Release IR-2011-103, Oct. 20, 2011, the Service announced retirement plan cost-of-living increases for 2012. The maximum elective deferral under 401(k) and similar plans increases from $16,500 to $17,000; the maximum annual pension under a qualified defined benefit plan increases from $195,000 to $200,000; and the maximum annual addition under a qualified defined contribution plan increases from $49,000 to $50,000. The maximum IRA contribution continues to be $5,000. Additional catch-up contributions may be made by individuals aged 50 or older. The Service also announced the 2012 limits for qualified transportation fringe benefits and medical savings accounts. Rev. Proc. 2011-52, 2011-45 I.R.B. 701; News Rel. 2011-104. Social Security beneficiaries will receive a 3.6% COLA, the first since 2009, and the Social Security taxable wage base increases from $106,800 to $110,100. SSA News Release, www.ssa.gov/pressoffice/pr/2012cola-pr.html. Unless extended, the 2011 employee tax rate of 4.2% will revert to 6.2% on March 1, 2012 (and the 4.2% pre-March rate would apply to no more than $18,350 of covered wages).

Supreme Court

Pension Plans. In *CIGNA Corp. v. Amara*, 131 S. Ct. 1866 (May 16, 2011), the Court unanimously vacated the lower court's award of additional pension benefits as a remedy for the employer's failure to communicate accurately the effects of its conversion of a traditional pension plan to a cash balance plan. The Court (1) ruled that ERISA section 502(a)(1)(B) did not authorize rewriting of the plan to provide more generous benefits, consistent with the misstatements concerning the effects of the conversion, and (2) rejected the argument that misstatements in the plan's summary plan description were "terms of the plan" that could be enforced under that section. Justice Breyer's majority opinion discusses possible remedies for fiduciary misrepresentations in terms that could significantly impact the administration of ERISA plans and communications between plan fiduciaries and plan participants.

Health Care Reform. On November 14, 2011, the Court agreed to hear a challenge to the constitutionality of the 2010 health care reform legislation. *State of Florida v. U.S. Dept. of Health and Human Services*, 2011 US LEXIS 8094, 8225, 8248, 8269. The Court has scheduled 5½ hours of oral argument in March 2012. In the most recent federal appeals court decision, the D.C. Circuit upheld the Act by a 2-1 majority. *Seven-Sky v. Holder*, 2011 U.S. App. LEXIS 22566 (D.C. Cir. Nov. 8, 2011).

Lower Courts

The Second Circuit followed other circuits in adopting the *Moench* presumption of prudence, first articulated in *Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995), as the standard of review for employer stock drop claims. *In re Citigroup ERISA Litigation*, 2011 WL 4950368 (2d Cir. 2011); *Gearren v. McGraw-Hill Cos., Inc.*, 2011 WL 4952628 (2d Cir. 2011). ■

Don't Forget to Review the Interest

By T. Angie Napier*

Taxpayers often overlook the interest computations at the close of an examination by the Service or at the settlement of a case with Appeals. There are often opportunities to reduce the net interest payable to the Service. However, taxpayers and their representatives may mistakenly rely on the interest bill received from the Service at the conclusion of their case without checking it for accuracy.

How complicated can it be to calculate deficiency and overpayment interest? Actually, it is quite complex. Did you know that a taxpayer can close an examination with no tax due, and yet owe deficiency interest? This article addresses just a few of the common interest benefits that are available and should be considered.

Revenue Ruling 99-40, 1999-40 I.R.B. 441 (Oct. 1999), offers the most common benefit that should be considered. Under this taxpayer-favorable ruling, taxpayers can reduce deficiency interest for a period of up to one year. This ruling should be considered when there is a new tax deficiency and a credit-elect on the original return of the deficiency year. A "credit-elect" is an overpayment of taxes on an income tax return that has been credited to estimated taxes for the taxpayer's following year. I.R.C. § 6402(b). The new deficiency could be self-assessed on an amended return or could be the result of an unfavorable adjustment at

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the close of an examination or at the settlement of a case with Appeals. Once a new tax deficiency is identified, the second step is to determine if there was a credit-elect on the original income tax return for the deficiency year.

For example, consider a taxpayer under examination who agrees to an adjustment resulting in tax of $15,000 for Year One. On the original Year One income tax return, the taxpayer overpaid income taxes by $10,000. This payment was credited as an estimated tax payment to Year Two. In our example, if the taxpayer did not utilize the $10,000 to satisfy any of the estimated tax payments in Year Two, then the taxpayer can suspend deficiency interest for a period of one year on up to $10,000 of the new tax deficiency. This is a time value of money concept. The taxpayer did not need the credit-elect to satisfy any of the estimated tax payments in Year Two and yet did not receive overpayment interest from the Service on this credit-elect. This benefit must be proactively requested by the taxpayer; in a majority of cases, the Service does not volunteer to give taxpayers this benefit.

As mentioned, the Service limits the suspension of deficiency interest to a maximum time of one year for taxpayers requesting the benefit of Revenue Ruling 99-40. This taxpayer-favorable ruling did not specifically address the issue of a taxpayer that is consistently overpaid and year-after-year credits its overpayment to the following tax year. Taxpayers have sought relief under the time value of money concept and argued that the deferral of deficiency interest should not be limited to one year. The most recent case on point is *FleetBoston Financial Corporation v. United States*, 483 F.3d 1345 (Fed Cir. 2007), where the Service had examined the income tax returns for FleetBoston and assessed deficiencies for tax years 1984 and 1985. FleetBoston had credit-elects on the original returns for 1984 and 1985 that were not needed to satisfy the estimated tax payments for the following year. FleetBoston continued to credit-elect its overpayment on its original income tax returns until tax year 1991, when FleetBoston received a refund of its overpayment. FleetBoston argued that the Service had use of the overpayments each year, without paying overpayment interest. The U.S. Court of Appeals rejected the broad time value of money arguments brought by FleetBoston and focused on the statutory construction of certain interest provisions. The court held that a tax is considered "paid" for purposes of calculating interest only out of funds from the taxpayer's tax account at the Service for that particular tax year. FleetBoston had argued that a tax should be considered "paid" out of all funds held by the Service as long as the funds were not needed to satisfy the taxes due for that particular tax account.

Another interest benefit which must be proactively requested from the Service is interest netting under section 6621(d). Interest netting allows the use of a net interest rate of zero for overlapping periods of equivalent tax overpayment and tax underpayment. This concept eliminates the rate differential between overpayment interest (interest paid by the Service) and deficiency interest (interest paid by taxpayers). The rate differential can be as high as 4.5%. Taxpayers and their representatives should review their interest computations for opportunities to reduce interest using interest netting. Taxpayers should file Form 843, Claim for Refund and Request for Abatement, to request interest netting.

A third interest issue to consider is "hot interest" under section 6621(c). Hot interest kicks in when a corporation has a large corporate underpayment (greater than $100,000) that remains unpaid for 30 days after the issuance of a 30-day letter or a balance due notice. Hot interest is an increase in the deficiency interest rate by two percentage points. It is important for taxpayers and their representatives to check the rates being applied in the deficiency interest computation. Hot interest may not be applicable to your client, but the Service may be computing deficiency interest at the hot interest rate if the taxpayer's account has been mistakenly coded that hot interest is applicable. This can be reviewed by checking the applicable rates being used in the deficiency interest computation against the timing of the 30-day letter and other correspondence from the Service. It is important to note that the balance due threshold of $100,000 is determined without consideration of any interest, penalties, or additions to tax. I.R.C. § 6621(c)(2)(B)(iii). For example, your client may have received a balance due notice from the Service with an amount due of $110,000. The balance includes $70,000 in tax; the remainder of the balance is penalties. This balance due notice alone should not trigger hot interest as the tax due is less than $100,000. The deficiency interest rates should be reviewed to ensure that the Service has not erroneously triggered hot interest rates.

There are many more opportunities to reduce the net interest payable to the Service. Other events which cause complexity and interest opportunities include carrybacks of net operating losses, net capital losses, and of credits. Representatives should periodically review their client's interest computations to ensure accuracy. A triggering event for the review of interest can be the close of an examination or the settlement of a case with Appeals. ■

OPINION POINT

Will Section 199 Stand the Test of Time?

By Vlad Frants*

Introduced in the American Jobs Creation Act of 2004 by Congress, the section 199 domestic production deduction was created to encourage manufacturing in the United States as well as certain other "production" activity. *See* David Freeman, *Section 199 Domestic Production Deduction: Time for a Closer Look*, Metropolitan Corporate Counsel, Nov. 2010, at 22. Section 199 currently reduces the effective tax rate on U.S. manufacturing (or production) income by allowing a deduction equal to nine percent of a taxpayer's "qualified production activities income." This article begins with a brief history of earlier provisions and then delves into the definition of what is meant by qualified production activities income, the eligibility of taxpayers to take the deduction, and other issues.

In 1962, in an attempt to inhibit the movement of U.S. export profits into foreign subsidiaries in tax haven jurisdictions, Congress enacted the foreign base company rules, which limited those tax benefits. Then, in 1971, Congress enacted the domestic international sales corporation (DISC) legislation, which was determined to constitute an illegal subsidy according to a panel established under the General Agreement on Tariffs and Trade. Congress then replaced the DISC legislation with foreign sales corporation (FSC) legislation. The FSC legislation, which lasted from 1984 until late 2000, offered exporters a federal income tax subsidy for operating through foreign sales corporations. In 1999, a World Trade Organization (WTO) panel determined, and the WTO Appeals Body confirmed, that the FSC regime was an unlawful subsidy which had to be eliminated. Congress then passed the FSC Repeal and Extraterritorial Income Exclusion Act of 2000, which significantly changed how export sales were taxed; the act introduced an extraterritorial income exclusion (ETI), which frustrated U.S. trading partners. The European Union, for example, imposed tariffs on numerous U.S. products in retaliation for the ETI export incentive. ETI was also eventually deemed to constitute an illegal subsidy and Congress ultimately repealed the ETI regime. With this background, Congress returned to the drawing board and devised another production incentive, one that was not targeted to export sales but instead incentivized domestic production irrespective of the final destination of the produced merchandise: the section 199 domestic production deduction.

Section 199 is, to say the least, extraordinarily complex. A similar provision was once part of the Canadian tax laws but was repealed because it was highly complex and difficult to administer and the numerous disputes and litigation between taxpayers and the Canadian tax authorities led Canada to reduce corporate tax rates instead. *See* Jasper L. Cummings, Jr. & Robert L. Hanson, American Jobs Creation Act of 2004: A Selective Analysis ¶ 1.03 (2005). Consider the rules for section 199 below.

Section 199 provides a qualified production activities deduction (QPAD) and applies to those taxpayers that derive income from qualified domestic production activities (QDPA). The amount of the QPAD is currently nine percent of the lesser of (1) the qualified production activities income (QPAI) of the taxpayer for the tax year or (2) taxable income (determined without regard to the effects of the deduction) for the tax year. I.R.C. § 199(a)(1). The deduction is based on a formula and not on actual outlays. However, the deduction cannot exceed 50% of the W-2 wages paid by the taxpayer. I.R.C. § 199(b)(1).

QPAI is the excess of domestic production gross receipts (DPGR) over the sum of (1) the cost of goods sold allocable to DPGR, (2) other deductions, expenses or losses directly allocable to DPGR, and (3) a ratable portion of other deductions, expenses, and losses not directly allocable to DPGR or to any other class of income. I.R.C. § 199(c)(1)–(2). DPGR consists of gross receipts derived from: (1) the lease, rental, license, sale, exchange or other disposition of (a) "qualifying production property" produced by the taxpayer in the United States (in whole or significant part), (b) any "qualified film" produced by the taxpayer, or (c) electricity, natural gas, or potable water produced by the taxpayer in the United States; (2) construction performed within the United States by taxpayers engaged in the active conduct of a construction trade or business; or (3) architectural or engineering services performed in the United States, by a taxpayer engaged in the active conduct of an engineering or architectural services trade or business, for U.S. construction projects. I.R.C. § 199(c)(4).

While these basic rules may seem mechanical, the deduction can have a counterintuitive effect, is full of interpretive issues, and is replete with computational complexity. Consider even the most basic premise: section 199 is supposed to provide a *domestic*

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production deduction. Yet, nearly 80% of the cost of a finished product could be produced overseas (*non-domestic*) and still meet a safe harbor to qualify as domestic production, and 80% or more could be produced overseas if the taxpayer could successfully argue that the U.S. production was nonetheless "substantial" in nature. Services (*not production*) that are "embedded" in the products can also qualify for the deduction. *See* David Freeman, *supra*, at 23. Consider two examples of the interpretive difficulties. First, section 199(c)(4)(A)(i)(I) states that qualifying production property gives rise to domestic production gross receipts to the extent that the property is "manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States." The term "by the taxpayer" is addressed by neither the statute nor legislative history and, although some guidance has been issued, it has historically been a gray area. *See*, *e.g.*, Notice 2005-14, 2005-7 I.R.B. 498. Second, the meaning of "[produced] in whole or in significant part [within the United States]" has also been an area involving some uncertainty. Guidance on this matter has made this issue somewhat simpler, though by no means simple. *See* Cummings & Hanson, *supra*, at ¶ 2.03. These are only two of a multitude of interpretive issues related to section 199.

In addition to the statute's counterintuitive consequences and interpretive issues, there are also special rules and other computation issues that add an additional level of complexity. These special rules address particular taxpayer situations and "include the application of the deduction to individuals, pass-through entities (such as partnership, S corporation, estates, trusts, and similar entities), cooperatives, and the timber industry. Section 199 adopts the concept of an 'expanded affiliated group' both to compute the deduction and then to allocate the deduction to the members of the expanded affiliated group." Cummings & Hanson, *supra*, at ¶ 2.03. As David Freeman aptly points out in his article, *supra*, at 24, the correct application of section 199 can be difficult for taxpayers whose business models involve one or more of the following:

- [Accounting systems that track revenue and expenses based on divisions, product lines and other broad criteria (as opposed to the "item" approach required in the [Section 199] computation);
- Shared production responsibilities through sub-contractor arrangements, whether acting as the sub-contractor or the customer of a sub-contractor;
- Provision of delivery services, installation services or warranties in connection with the produced property;
- Production of products with multiple components with only some produced by the taxpayer;
- Unusual or non-recurring types of income including Subpart F inclusions, litigation settlements, gains on the disposition of capital assets;
- Unusual or non-recurring types of expenses and expenses that may relate to the stewardship of or allocation of costs and revenue among subsidiary and affiliated businesses.]

"In a testament to the broad reach and complexity of [Section 199], the IRS had designated [Section 199] a "Tier I Issue." Additionally, the Service "has admitted that the complexity of the rules related to [Section 199] might lead to substantial audit resources being expended during examination of any deduction claimed by the taxpayer." Beth Benko, *Section 199: Deduction Relating to Income Attributable to Domestic Production Activities*, 510-2nd T.M., at 2. While section 199 was moved from active to monitoring status in 2010, the likelihood of a Service audit of the deduction remains high today.

Recently, House Ways and Means Committee leaders have suggested that they are willing to consider eliminating the section 199 manufacturing deduction as part of a wider effort to reduce the corporate tax rate. Brett Ferguson & Heather M. Rothman, *Lawmakers Open to Trading R&D Credit, Section 199 Deduction to Lower Corporate Rates*, June 3, 2011, at http://www.bnasoftware.com/News/Tax_News/Articles/Lawmakers_Open_to_Trading_R_and_D_Credit_Section_199_Deduction_for_Lower_Corporate_Rates.asp. Practically speaking, eliminating the deduction would save the government money as well. One estimate of the ten-year budget impact related to the enactment of section 199 would be a decrease in tax revenue of approximately $76.5 billion. *See* Staff of Joint Comm. on Taxation, General Explanation of Tax Legislation Enacted in the 108th Congress 546 (App. Table) (JCS-5-05) (2005), *available at* http://jct.gov. In addition, the Treasury Department has indicated that, had the provision been repealed in 2008, revenues would have increased by $258 billion through 2017. Office of Tax Policy, U.S. Department of Treasury, Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century 48 (Table 3.1) (2007), *available at* http://www.treasury.gov/resource-center/tax-policy/Documents/Approaches-to-Improve-Business-Tax-Competitiveness-12-20-2007.pdf.

To the extent that it could be argued that the high cost (and complexity) is justified because it keeps manufacturers producing in the United States, perhaps a reduction in corporate tax rates would fulfill the same objective at a lower overall cost. It will be interesting to see if section 199 survives the test of time or whether the U.S. follows in the steps of Canada and replaces the deduction with a reduction in corporate tax rates. ■

SPECIAL REPORT

Social Security Benefits 101: The Windfall Elimination Provision*

By Francine J. Lipman† and James E. Williamson‡

Many individuals feel overwhelmed by investment and retirement decisions. Paralyzed by their own lack of financial knowledge and the increasing complexity of retirement plans and the Social Security and Medicare systems, they acknowledge they don't even know where to begin. As a result, too many ignore the issue and suffer the financial consequences when they are least able to remedy the situation. In a recent study, more than 33% of individuals who are saving for retirement admitted that they do not feel confident about their financial knowledge and expressed confusion about the various components of their retirement plans—including pensions, 401(k) plans, Social Security, and Medicare. *See Understanding the Accidental Investor: Baby Boomers on Retirement* (2011), at http://corp.financialengines.com/employer/Accidental_Investor_April2011.pdf.

While most individuals ultimately rely on Social Security benefits for an increasingly greater percentage of their retirement income, they do not even mention Social Security benefits without prompting about the details of their retirement plans. Social Security benefits seem to be an afterthought or a retirement resource that doesn't need to be analyzed, planned for, or even understood. Many seniors don't want to admit their significant dependence upon Social Security benefits for all or most of their retirement income. In 2010, without Social Security benefits, the number of people aged 65 and older living in poverty would be higher by almost 14 million—increasing the elderly poverty rate by 400%, or up to 45% of all seniors. Yet most Americans do not have basic knowledge about the mechanics of the Social Security benefits formula. We have addressed this gap in understanding in prior scholarship, including two *NewsQuarterly* articles covering various aspects of the "Social Security Benefits Formula 101."§ This article adds to this scholarship by addressing a unique provision for individuals who qualify for both Social Security benefits and for pensions from work that is not subject to or included in the Social Security system.

Investments 101

A fundamental concept of successful investing is the age-old adage "don't put all of your eggs in one basket." As such, retirees should plan to have a variety of sources of post-work income. Diversification of income can protect a retiree from outliving retirement resources. One way to achieve diversification is to consider employment opportunities with government agencies that do not participate in the Social Security tax/benefit system (noncovered work) before, after, or during your participation in employment that is subject to Social Security taxes and qualifies for Social Security benefits (covered work). Approximately 25% of all public employees, or more than five million state and local workers and one million federal workers participate in alternative plans to Social Security. These employers and employees do not pay Social Security taxes or receive Social Security credit for their wages. These non-Social Security pension benefits can supplement and diversify a retirement income portfolio that includes Social Security benefits if the worker can structure his career to otherwise qualify for Social Security benefits. Not surprisingly the interplay of Social Security with alternative pensions can be confusing and involves both traps for the unwary and rewards for strategic planners. Public employers and their employees, including many state and local universities and schools that are financially strapped and challenged to attract top talent, should carefully consider promoting these retirement plans as an opportunity to supplement a worker's existing Social Security and Medicare benefits. This article describes this interplay, demonstrates undue hardships in the existing structure, and suggests strategies for maximizing aggregate retirement income benefits.

Social Security Benefit Windfalls and Burdens

The Social Security benefit formula is designed to provide an income safety net for workers during their retirement years. To achieve this goal, the benefit formula is structured to replace a percentage of, rather than all of, a worker's pre-retirement income. To ensure that qualifying seniors do not have to suffer aged

* An earlier version of this article was published in the *Orange County Lawyer* magazine.

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§ Francine J. Lipman and James E. Williamson, "Social Security Benefits Formula 101: A Practical Primer," *NewsQuarterly* (Summer 2010) and "Social Security Spouse and Survivor Benefits 101: Practical Primer Part II (Or Another Reason to Put a Ring on It)," *NewsQuarterly* (Fall 2010).

poverty, the formula necessarily replaces a greater percentage of covered wages for lower-income workers than for higher-income workers. For example, the lowest-earning workers (up to $9,000 (average wage-inflation adjusted income) per year) receive a Social Security benefit that equals 90% of their pre-retirement covered earnings, while the average replacement rate for the highest-earning workers (up to $95,136 (average wage-inflation adjusted income) per year in Social Security covered wages) is about 25%.

Prior to congressional reform in 1983, employees who primarily worked in jobs that were not covered by Social Security, but earned an alternative pension and also qualified for Social Security benefits—because they worked for at least ten years (40 quarters) in Social Security covered jobs—in many cases received a windfall Social Security benefit. Because the Social Security benefit formula does not include noncovered wages, these workers were treated as lower-lifetime income earners as compared to their actual higher lifetime earnings. Under the traditional Social Security formula the lowest-lifetime earners receive a higher pre-retirement income replacement rate (as high as 90%) than higher-lifetime earners (with overall replacement rates as low as 25%). This mischaracterization results for several reasons, including that the Social Security benefits formula averages Social Security covered earnings for the 35 highest wage earning years over 35 years (including any zero years, which lowers the average for otherwise higher-income earners with noncovered wages). Because this formula does not capture noncovered wages, the calculation can provide a potential windfall benefit by placing more of an employee's wages in the higher benefit ranges providing a 90% or 32% benefit rather than the higher-income, lower-benefit percentage range of 15%.

Congress enacted and President Reagan signed into law on April 21, 1983, the Windfall Elimination Provision (WEP) to mitigate this potential windfall. While members of Congress had introduced an alternative bill that would have perfectly captured and reversed the windfall benefit, the Social Security Administration did not have historical information regarding noncovered wages to implement this targeted solution. Unfortunately, the WEP passed into law (while better than harsher alternatives also proposed) is rough justice in that it does not eliminate the entire windfall for higher-income individuals and is overly punitive for lower-income individuals. Indeed, even with the WEP maximum, Social Security wage-earners receive a better return on their Social Security tax dollars than they would have received had all of their earnings been included in the Social Security tax/benefit system. This is not true for lower-income workers who are unfairly penalized by the WEP. In all cases lower-income workers (45% of average wages) receive a Social Security return that is less than the return they would have received had the benefit been based upon all of their earnings. For an excellent analysis of the distributional effects of the WEP, see Jeffrey R. Brown & Scott Weisbenner, *The Distributional Effects of the Social Security Windfall Elimination Provision*, at http://www.nber.org/programs/ag/rrc/08-05%20Brown,%20Weisbenner%20FINAL.pdf.

The complexity, lack of transparency, and regressive impact of the WEP have generated intense opposition by those affected adversely by the WEP and their advocates. Congressional bills to eliminate or modify the WEP are routinely introduced. Representatives and Senators from California (153,504 Social Security beneficiaries subject to the WEP) as well as from other states heavily affected by the WEP have proposed repealing the WEP (at an approximate cost of $40.1 billion from 2008-2017).

To explain all of the implications of the WEP for beneficiaries, we first present the Social Security benefit formula. Next, we detail the WEP and its impact on the Social Security benefit formula using several detailed examples to illustrate how different situations and economic circumstances are, or are not, affected by the WEP. Finally, we conclude with a summary of the specific issues individuals need to consider when they engage in strategic analyses of potential employment changes between employment that is covered by Social Security taxes/benefits and employment that is subject to alternative plans.

The Social Security Retirement Benefit Formula 101

The Social Security retirement benefit that a worker will receive, if retiring at full retirement age (age 66 (for those born between 1943 and 1954)), is called the primary insurance amount (PIA). PIA is also used to calculate other family benefits based upon the worker's wage records, including spousal and survivor benefits. Congress designed PIA to provide a greater replacement rate (a higher ratio of Social Security benefits to average indexed monthly lifetime earnings) for lower-lifetime wage earners than higher-lifetime wage earners to provide all qualifying seniors with anti-poverty relief during their retirement years.

The first calculation used in determining PIA is a worker's average wage-indexed monthly earnings (AIME) on which Social Security taxes were paid during the 35 highest qualifying earning years. PIA includes 90% of the first level (called a bend point, which is adjusted for wage inflation each year) of AIME. The second level of AIME (from bend point one to bend point two) is included in PIA at 32% of that amount. The third level is measured from bend point two to the maximum AIME. PIA includes only 15% of this amount. This calculation is illustrated in Table I, for a worker who reaches age 62 (the age at which PIA is determined) in 2011, with an AIME of

Table I
Calculation of PIA for 35-Year Maximum Wage Earner

	FIRST BEND POINT		SECOND BEND POINT		MAXIMUM INCOME LEVEL	
0	$749		$4,517		$7,928	
Range	($749 * 0.90)	+	(($4,517 – $749) * 0.32)	+	(($7,928 – $4,517) * 0.15)	
PIA	$674	+	$1,206	+	$512	= $2,392

Table II
Substantial Earnings as Defined by the Windfall Elimination Provision

YEAR	SUBSTANTIAL EARNINGS ($)
1937-54	900
1955-58	1,050
1959-65	1,200
1966-67	1,650
1968-71	1,950
1972	2,250
1973	2,700
1974	3,300
1975	3,525
1976	3,825
1977	4,125
1978	4,425
1979	4,725
1980	5,100
1981	5,550
1982	6,075
1983	6,675
1984	7,050
1985	7,425
1986	7,875
1987	8,175
1988	8,400
1989	8,925
1990	9,525
1991	9,900
1992	10,350
1993	10,725
1994	11,250
1995	11,325
1996	11,625
1997	12,150
1998	12,675
1999	13,425
2000	14,175
2001	14,925
2002	15,750
2003	16,125
2004	16,275
2005	16,725
2006	17,475
2007	18,150
2008	18,975
2009-11	19,800
2012	20,475

$7,928 (maximum AIME, $95,136 per year, for individuals reaching 62 in 2011).

As illustrated, the worker paying the maximum amount into the Social Security system for 35 years would receive a monthly PIA of $2,392 or $28,704 annually at full retirement age. However, a middle-income worker paying into the Social Security system on $54,204 ($4,517 * 12) would receive a monthly benefit of $1,880 ($674 + $1,206) or $22,560 annually. This example illustrates the benefit advantage to the middle-income worker relative to the higher-income worker. The higher-income worker receives only $512 (27%) more per month than the middle-income worker while having paid 76% more in Social Security taxes. When compared to the lower-income worker, the higher-income worker pays more than 10 times as much tax as does the lower-income worker while receiving a benefit of less than 4 times that of the lower-income worker. This progressive benefit formula (coupled with a regressive tax structure) is consistent with the anti-poverty relief and safety net goals of the Social Security benefit system.

Details of the WEP

The WEP is intended to remedy the unintended windfall inherent in the design of the Social Security benefit formula for individuals who receive pension benefits from noncovered work in addition to Social Security benefits. Because the Social Security benefit formula only includes covered wages in its analysis, these individuals are treated as lower-income earners relative to their actual earnings. Because the Social Security benefit formula is designed to provide a higher replacement rate for lower-income individuals as compared to higher-income individuals, these individuals often receive a higher replacement rate than they would receive if all of their income were covered by Social Security.

The WEP reduces the Social Security benefit that such individuals would otherwise receive by modifying the PIA calculation formula. In the formula, the 90% benefit rate is reduced to 40% for the first range of covered wages—a maximum of $375 in 2011 (50% of the first range of covered wages—for beneficiaries reaching 62 in 2011, $375 = 50% of $749). However, the 90% rate is not reduced if the worker has at least 30 years of "substantial earnings" in Social Security covered employment (Table II). If a worker has 21 to 29 years of "substantial earnings," the 40% rate is increased in 5% increments up to 85% in year 29 and full benefits of 90% in year 30 (Table III).

The WEP is capped for individuals who receive a relatively low pension benefit for their noncovered wages. The WEP reduction to the worker's Social Security benefit cannot be more than one-half of the alternative pension benefit. While derivative Social Security benefits, such as spousal and dependent benefits are calculated based upon PIA after any WEP reduction, survivor benefits are not subject to the WEP. This exacerbates the potential burden and

Table III
Percent of Factor Reduction

YEARS OF SUBSTANTIAL EARNINGS	PERCENT FACTOR
30 and above	90%
29	85%
28	80%
27	75%
26	70%
25	65%
24	60%
23	55%
22	50%
21	45%
20 or less	40%

benefits of the WEP and should be included in any analysis of its impact.

In addition to the WEP, another provision—the Government Pension Offset (the GPO)—adjusts any spousal benefit for a worker who has noncovered wages. Similar to the WEP, Congress enacted the GPO in 1977 to make certain that a worker does not receive a spousal benefit in addition to her noncovered pension because relative to a similarly situated couple, where both spouses are covered by Social Security, the spousal benefit is considered a windfall. The presumption is that the government pension for noncovered workers is intended to replace both Social Security and a private sector pension. The GPO reduces spousal benefits by $2 for every $3 of any alternative Social Security government pension. While the focus of this article is the WEP, the Social Security Administration website has an informative publication on the GPO at www.ssa.gov/pubs/10007.html as well as a GPO calculator at www.ssa.gov/retire2/gpo-calc.htm.

An Example of Changing from Covered Employment to Noncovered Employment

Professor Adams worked for Private University for fifteen years subject to Social Security and Medicare taxes. She then accepted a position at State University where Social Security taxes were not withheld from her pay because the state system provided an alternative pension benefit to its employees. Professor Adams reached age 62 on January 15, 2011.

The calculation of Professor Adams' PIA is illustrated in Table IV. We have assumed that she, for each of fifteen years, earned the maximum amount of Social Security covered wages ($95,136 in 2011). However, because AIME is based on the average of the taxpayer's 35 highest qualifying earning years or 420 months (35 * 12 = 420 months), **including zero income years**, for purposes of calculating the Social Security benefit, Professor Adams' AIME is $3,398 [($95,136 * 15 = $1,427,040) / (420) = $3,398].

While the benefit percentage in the lowest income range for Professor Adams has been reduced from 90% to 40% by the WEP, she is entitled to 48% of the benefit she would have been entitled to if she had 35 years of covered wages instead of only 15 years ($1,148/$2,392 maximum earner benefit). While any derived spousal benefits will be based upon her PIA of $1,148, the survivor benefit will be increased to $1,522 [(90% * $749) + (32% * ($3,398 – $749))].

If Professor Adams had worked only ten years for Private University (the minimum years required to qualify for Social Security retirement benefits), her PIA would have been $785 based on an AIME of $2,265 (($95,136 * 10)/420), or 33% of the 35-year maximum earner benefit. Any derivative survivor benefits will be increased to $1,159 [(90% * $749) + (32% * ($2,265 – $749))] (Table V).

Table IV
Calculation of Professor Adams' PIA
(15 years in Social Security system)

	FIRST BEND POINT		SECOND BEND POINT		MAXIMUM INCOME LEVEL	
0	**$749**		**$4,517**		**$7,928**	
Range	($749 * 0.40)	+	(($3,398 – $749) * 0.32)	+	(($3,398 – $4,517) * 0.15)	
PIA	$300	+	$848	+	$0	= $1,148

Table V
Calculation of Professor Adams' PIA
(10 years in Social Security system)

	FIRST BEND POINT		SECOND BEND POINT		MAXIMUM INCOME LEVEL	
0	**$749**		**$4,517**		**$7,928**	
Range	($749 * 0.40)	+	(($2,265 – $749) * 0.32)	+	(($2,265 – $4,517) * 0.15)	
PIA	$300	+	$485	+	$0	= $785

If Professor Adams had worked for Private University for 20 or 25 years her AIME would have been $4,530 (($95,136 * 25)/420) or $5,663 (($95,136 * 20)/420) and her PIA would have been $1,508 (63% of the 35-year benefit) or $1,865 (78% of the 35-year benefit) (Table VI) with survivor benefits of $1,882 and $2,052, respectively.

If Professor Adams had worked 30 or more years for Private University there would be no reduction in the percentage benefit allowed for the first income range, but her AIME would be lower than if she had worked for 35 years. As a result, her PIA would be $2,222, or 93% of the 35-year maximum earner. And, if she had worked at least 35 years for Private University and then switched to State University there would be no effect on her Social Security retirement benefits although she would have been relieved from paying Social Security taxes in these subsequent years.

Similar PIA results for middle-, lower-, and highest-income earners with the WEP and the same wage scenario without the WEP are set forth in Table VII. (Note that these PIA amounts might be higher to the extent that the WEP exceeds one-half of the alternative pension amount.) The Social Security Administration has an online Social Security benefits calculator, which includes the WEP, at www.ssa.gov/retire2/anyPiaWepjs04.htm.

As Table VII illustrates, the WEP affects low earners proportionally more than higher earners. This is a direct result of its structure. First, the WEP reduction applies only to the first range of PIA ($749 in 2011). For all workers with covered AIME above this range, the maximum reduction is $375 per month, or $4,500 per year. As AIME rises, the reduction becomes a smaller percentage of PIA (starting at 50% reduction $375/$749 per month and dropping to less than 5% for a maximum earner $375/$7,928). Second, the WEP structure provides that if a worker has more than 20 years of coverage, defined as any year in which an individual has substantial covered earnings ($20,475 in 2012), she earns a 5 percentage point increase in the 40% rate applied to the first AIME range. Thus, at 30 years of coverage or more, the rate returns to the 90% rate applicable without the WEP. Both of these provisions adversely affect lower-income earners relative to higher-income earners.

Table VII demonstrates that even if a lower-income worker has 35 years of covered earnings she is entitled to only 59% of the Social Security retirement benefit she would otherwise receive if she had not earned a pension from noncovered wages. By way of comparison, middle- and higher-income earners can effectively eliminate the WEP by participating in the Social Security system for at least 30 years. Notably, these reduced PIAs are used to derive spousal and dependent derivative Social

Table VI
Calculation of Professor Adams' PIA
(25 years in Social Security system)

		FIRST BEND POINT		SECOND BEND POINT		MAXIMUM INCOME LEVEL
0		**$749**		**$4,517**		**$7,928**
Range		($749 * 0.65)	+	(($4,517 – $749) * 0.32)	+	(($5,663 – $4,517) * 0.15)
PIA		$487	+	$1,206	+	$172 = $1,865

Table VII
PIA for Social Security Beneficiaries Subject to the WEP and Not Subject to WEP

YRS. COVERED	LOWER-INCOME ($18,000)		MIDDLE-INCOME ($54,204)		HIGHEST-INCOME ($95,136)	
	WEP	NO WEP	WEP	NO WEP	WEP	NO WEP
10	$171 / 44%	$386	$473 / 56%	$847	$785 / 64%	$1,226
15	$257 / 44%	$579	$680 / 65%	$1,054	$1,148 / 72%	$1,588
20	$335 / 47%	$709	$886 / 70%	$1,260	$1,512 / 78%	$1,951
25	$403 / 52%	$777	$1,280 / 87%	$1,467	$1,865 / 91%	$2,052
30	$472 / 56%	$846	$1,673 / 100%	$1,673	$2,222 / 100%	$2,222
35	$540 / 59%	$914	$1,880 / 100%	$1,880	$2,392 / 100%	$2,392

Security benefits. Thus, not only is the lower-income worker subject to the WEP, but if her spouse and/or dependents receive a Social Security benefit based upon her work record they will also suffer the burden of the WEP. Therefore, lower-income senior households are harmed disproportionately and exponentially. Upon the death of the worker, any survivor benefits are not subject to the WEP and are increased to the benefit without the WEP reduction.

Maximizing Benefits from a Career Combining Social Security Covered and Noncovered Employment

If everything else is equal, the Social Security benefit calculation is not affected by whether a qualifying year (or quarter) occurred at the beginning or the end of the worker's career. Therefore, there is, at least theoretically, the possibility of increasing the worker's overall retirement benefits by working in the noncovered employment first and the covered employment at the later part of one's career. This is illustrated by comparing two careers that are identical except for this timing difference.

Maria Adelante began working for State University at age 26; it had a defined contribution pension plan as an alternative to Social Security. At age 56, she transferred to Private College, which withheld Social Security and Medicare taxes from her pay for ten years (40 quarters) until she reached her full retirement age of 66. Jesus Pasado, on the other hand, worked at Private College from age 26 to age 36. He then transferred to State University and participated in its defined contribution plan until his full retirement age of 66.

Because the Social Security benefits formula does not take into consideration when the qualifying years occurred, other than the wage-level inflation adjustment, if we assume everything else is equal, Maria will receive exactly the same Social Security benefits as Jesus. Assuming, for purposes of this example, that they both had the maximum amount of covered Social Security wages for the ten years that they worked for Private University, they would both have a PIA of $785 [($749 * 0.40 = $300)] + [(($2,265 – $749) * 0.32 = $485)] based on an AIME of $2,265 [($95,136 * 10 / 420) = $2,265].

Maria, however, will have almost twice the amount in her defined contribution account at age 66 as Jesus' balance. While the Social Security benefit calculation does not consider when the qualifying years were worked, deposits in defined contribution accounts do accrue earnings tax-deferred over time. If we assume that Maria and Jesus will both average an annual rate of return of 6% on their defined contribution accounts, at age 66, Maria's account will be about 1.8 times as large as Jesus' account, because it continued to accrue additional benefits during the last ten years that Maria worked for Private University.

Summary and Conclusions

Individuals contemplating changing jobs from covered to noncovered employment (or vice versa), or considering any noncovered employment must include the impact of the WEP on their family Social Security benefits in the analysis. The analysis should include the following key strategic objectives.

To qualify for Social Security retirement and Medicare benefits a worker, or a worker's spouse (or former spouse from an at least ten-year marriage) must have at least ten qualifying years (40 quarters) of minimal covered wages. Our analysis indicates that, everything else being equal, these ten years could be more beneficial if worked at the end of the worker's career rather than earlier in the worker's career.

In addition, the impact of the WEP is reduced if a worker has substantial covered earnings in more than 20 years. The benefit of meeting these earning thresholds for every year of covered employment is significant not only for the worker's Social Security benefits, but also for any derivative benefits. The ability to qualify for mitigation of the WEP could have a meaningful impact on a retiree's household retirement income. Notably, once a worker has at least 30 years of substantial covered earnings, the WEP is completely eliminated for the worker as well as for any spousal or dependent derivative benefits.

Most critically, understanding the mechanics of the WEP and using the work incentives and disincentives strategically could make noncovered employment attractive as an opportunity to diversify one's retirement income portfolio as well as supplement unreduced Social Security benefits. Finally, as we continue to debate Social Security reform, the disproportionate impact of the WEP on lower-income workers must be addressed and remedied. The most vulnerable public workers and their families, who like most retirees are ill equipped to understand the technical, opaque morass of the WEP, deserve nothing less. ■

KATIE TOLLIVER

time, Katie is providing access to tax justice in rural Appalachia and serving desperately underserved communities. In Katie's own words:

NQ What made you first apply for the Fellowship?

KT I started volunteering with the Legal Aid Society of Middle Tennessee and the Cumberlands (LASMTC) when I was in high school. Initially, I interpreted meetings with Hispanic clients and translated community education materials. At that point, I planned to pursue a career in which I could help people, but I did not plan to become an attorney. However, volunteering at LASMTC showed me the impact that focused, systemic legal advocacy can have. It can make a significant and long-term impact on clients. I was lucky to work for a legal aid program that identifies tax problems as a core poverty issue. Working with an attorney showed me that low-income tax advocacy is about more than just money; it is about getting clients back on their feet and breaking the economic cycle that traps them. I wanted to find a way to practice tax law in the public service field, but there is little funding for that work. As soon as I heard about the Fellowship, I knew I wanted to apply.

NQ Tell us about the area your clinic serves.

KT My clinic serves eight Tennessee counties in rural Appalachia. In that area, widespread poverty, a lack of available jobs, the nation's worst methamphetamine epidemic, geographical isolation, and other factors have combined to make people in this region exceptionally impoverished with few resources to turn to for help. For many reasons, people in this area seem to have more tax problems than others. A lack of education and high illiteracy rates create barriers to properly filing taxes and when tax problems come up, legal help is not accessible. Many of the communities I serve not only have no tax attorneys; they have no attorneys, period. Many people lack transportation and the Appalachian Mountains make traveling from one community to another long and difficult.

I can't always rely on sending letters to clients because some can't read them. I have clients who have no electricity. Some rely on well water that isn't safe. It is rare that I have a client who has Internet access. There are parts of my service area in which cell phones are worthless because the mountains block all cell phone signals. Some people in this area don't have any kind of phone. Rural Appalachia is still very cut off from the rest of the country—geographically, culturally, and technologically.

NQ How does your service area affect how your clinic operates?

KT Because of that isolation, the traditional clinic model doesn't work very well. I had to find a way to leverage scarce financial and legal resources to reach clients in isolated communities. For that reason, I decided to form partnerships with a network of established, well-grounded community organizations. By training employees or volunteers within those organizations to recognize and ask about tax problems, the clinic can reach out to people in rural communities and provide tax advocacy to clients who would not otherwise be able to access legal help. I work with schools, health clinics, domestic violence shelters, and other organizations to reach clients who have nowhere else to turn.

The idea behind this partnership network is simple. The partnership is efficient because it reaches potential clients in places they already go, using people who are already there. There is no way I could effectively reach clients by working on my own, which is why I do intake through partner organizations. Clients are likely to tell people they know about their tax problems. A receptionist at the local health clinic may hear, "I can't pay my bill because the IRS is taking part of my Social Security check." That receptionist refers the client to the tax clinic so that we can resolve the problem. Our partners refer clients to us and also distribute our community education materials.

Another strategy that has been effective is to hold one-day tax clinics. I advertise the clinics at local partner organizations, schools, churches, and other places. These clinics are an effective way to triage clients and I can meet with several clients back-to-back in one location. I have partnered with other non-tax attorneys at LASMTC to do the clinics as well, which has been very successful.

NQ Can you give examples of the types of tax issues you deal with in providing tax assistance to low-income taxpayers?

KT There is a huge range. Because such a high percentage of individual income tax audits focus on people who claim the Earned Income Tax Credit (EITC), I always have several cases involving disallowance of the EITC and other credits. I also represent a number of self-employed clients who have disallowed business expenses. I do a lot of work on the collections end to get eligible clients in Currently Not Collectible Status or to get Offers in Compromise approved. I take innocent spouse and injured spouse cases, along with a wide variety of other cases. I frequently refer clients to other attorneys within LASMTC for assistance with other legal problems. The other attorney can work to solve a

housing, consumer, health insurance, or other problem while I work on the tax issues.

NQ What has been your most rewarding experience as a Fellow?

KT There have been many. It is always rewarding to prove that a client does not owe a tax debt, or to get a big refund. However, I have found that the most rewarding cases aren't always the ones in which large sums are involved. I have a client who is terminally ill. She lives on about $600 per month. The IRS was levying 15% of that amount. Because of that levy, she was not able to pay for medication she needed and was running out of food each month. She was paying her rent and barely scraping by. I was able to stop the levy and get some payments refunded. When I told her she would get a refund, she broke down crying. She said she had not been able to sleep because she was so worried about how she was going to stretch her food budget. It wasn't a lot of money, but it really had a positive impact.

NQ What has been your biggest challenge in the position?

KT The biggest challenge is definitely finding funding to continue the tax clinic. We have more clients who need our services than ever, but there are fewer sources of funding for public service work. Tax advocacy can help people get back on their feet, pay for needed medicine, or get housing after a period of homelessness. However, there is even less funding for tax advocacy than for other legal services.

NQ Do you have any immediate plans after the Fellowship?

KT I want to continue running the tax clinic. However, the clinic can't continue to operate without additional funding. I have recently started a medical–legal partnership that will expand the clinic's reach to help more clients. I would like to see that project grow, and I think it will be tremendously beneficial for clients in rural Appalachia.

Sargent Shriver said, "The only genuine elite are those men and women who give their lives to justice and charity." Katie and her colleagues at LASMTC are genuine elite. Nevertheless, without ongoing support the programs Katie has launched through Appalachian Community Partnership for Tax Advocacy will not survive—it takes a village to provide access to tax justice. Katie welcomes your suggestions and assistance at:

Legal Aid Society of Middle Tennessee and the Cumberlands
P.O. Box 5209
Oak Ridge, TN 37831
Phone: 865/483-8454
E-mail: ktjones@las.org. ■

Since 2009, the Section has funded two Public Service fellows each year, including Katie and these other amazing young lawyers (fellowship details are available at **http://www.americanbar.org/groups/taxation/awards/psfellowship.html**):

- Laura Newland (AARP's Legal Counsel for the Elderly, 2009–11)
- Vijay Raghavan (Prairie State Legal Services, 2009–11)
- Douglas Smith (Community Action Program of Lancaster County, Pennsylvania, 2010–12)
- Sean Norton (Pine Tree Legal Assistance, Inc., 2011–13)
- Anna Tavis (South Brooklyn Legal Services/Immigrant Workers' Tax Advocacy Project, 2011–13).

TAX Bites Revisits the 1986 Act Era

By Gail L. Richmond*

The names may have changed, but the rhetoric remains the same. In celebration of the 1986 Act's 25th anniversary, Tax Bites offers some remarks from the 1985 and 1986 volumes of *Congressional Record*.

I have never viewed taxation as a means of rewarding one class of taxpayers or punishing another. If such a point of view ever controls our public policy, the traditions of freedom, justice and equality of opportunity, which are the distinguishing characteristics of our American civilization, will have disappeared and in their place we shall have class legislation with all its attendant evils. The man who seeks to perpetuate prejudice and class hatred is doing America an ill service. In attempting to promote or defeat legislation by arraying one class of taxpayers against another, he shows a complete misconception of those principles of equality on which the country was founded.

—*Senator Dennis DeConcini (January 31, 1985)*

Now, when you look back on it, frankly, the record of the two parties is not very good. On this side of the aisle perhaps we have been most guilty of paying for programs with red ink, expanding the spending without expending the money in the till to pay for those programs, and I would have to say that this administration, quite frankly, has erred on the other side. They have loved to give those tax cuts, but they have written them with red ink. They have paid for those tax cuts out of the deficit, with money that we did not have. Each side of this process has been giving in to what has been politically easy. It is easy to give tax cuts. None of us ever likes to oppose tax cuts.

—*Senator David Boren (October 4, 1985)*

But I come back again to the perception of fairness. If the public does not perceive the Tax Code as fair, then that does not bode well for this country or for this Congress. Consequently, we will enact a minimum tax taxing corporations, taxing wealthy individuals, and somehow requiring that they must pay some tax, no matter how legitimate their deductions, no matter how worthy the social purposes that they support, because we cannot have those stories appear somehow they have evaded, avoided taxation because the impression given is that they have done it immorally, unethically, illegally. They have not. They have undertaken deliberate actions which the tax law encouraged them to undertake.

So there is a down side. But I think on balance it is more important that they pay some tax no matter how honest, legitimate, decent their deductions may be than they pay no tax and the public thinks that the Tax Code is unfair or immoral or unethical.

—*Senator Robert Packwood (October 8, 1985)*

I am also worried that this legislation harms the progressivity of the Tax Code. I have seen the charts presented by a number of members which demonstrate how the current system's loopholes make it less progressive than the stripped-down structure that this bill enacts. But the simple fact is, this bill leaves us with only two rates: 15 and 28 percent. It leaves a taxpayer with an income of $50,000 paying the same percentage on his income as someone making $500,000. No matter how unprogressive the current system may be, taxing individuals at such disparate levels of income at the same rate is just plain unfair.

—*Representative Mel Levine (September 25, 1986)*

* Nova Southeastern University Law Center, Davie, FL.

Boxscore

Since October 2011 the Section has coordinated the following government submissions, which can be viewed and downloaded free of charge from the Section's website at http://www.americanbar.org/groups/taxation/policy.html.

Submissions and Comments on Government Regulations, Administrative Rulings, Blanket Authority and ABA Policy

TO	DATE	CODE SECTION	TITLE	COMMITTEE	CONTACT
Internal Revenue Service	1/05/2012	482	Comments on the Advance Pricing and Mutual Agreement Program	Transfer Pricing	E. Miller Williams, Jr.
Internal Revenue Service	12/06/2011	32, 6695(g)	Proposed Regulations Changing Tax Preparer Due Diligence Standards Relating to the Earned Income Tax Credit (Reg. 140280-09)	Low Income Taxpayers	Joseph Barry Schimmel, George L. Willis
House Committee on Ways & Means, Senate Committee on Finance	12/02/2011	108, 197, 465, 708, 751, 1402	Options for Tax Reform Relating to Partnerships	Partnerships and LLCs	Jeanne Sullivan
House Committee on Ways & Means, Senate Committee on Finance	12/02/2011	279, 475, 1032, 1091, 1234, 1234A, 1235, 1236, 1256	Options for Tax Reform Relating to Financial Transactions	Financial Transactions	Lucy Farr
House Subcommittee on Financial Services and General Government, Senate Subcommittee on Financial Services and General Government	11/09/2011	n/a	Internal Revenue Service Funding*	Section of Taxation	William M. Paul
Internal Revenue Service	10/26/2011	362(e)	Comments on the Application of Section 362(e) to Partnership Interests	Partnerships and LLCs	Matthew Lay, Stanley E. Ramsay
Internal Revenue Service	10/18/2011	6109	Comments on Proposed Regulations That Would Require Fingerprinting of Participants in the Preparer Tax Identification Number Program (Reg. 116284-11)	Administrative Practice, Standards of Tax Practice	Armando Gomez
Internal Revenue Service	10/14/2011	162(m)	Comments on Proposed Regulations Under 162(m)	Employee Benefits	Adam B. Cohen, Joni Andrioff

The technical comments and blanket authority submissions 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.

*Represents ABA policy.

Career Resources from the Tax Section

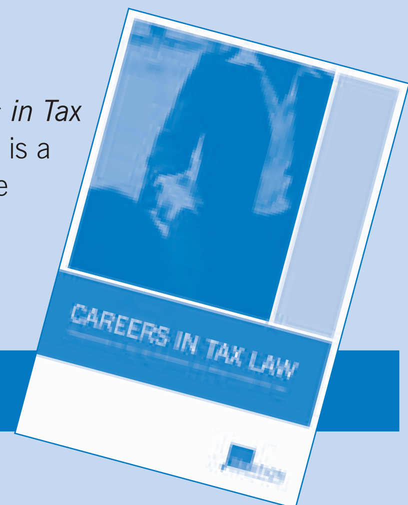
Careers in Tax Law Panels at Law Schools

The Section of Taxation co-hosts Careers in Tax Law panels at law schools around the country to introduce J.D. and LL.M. students to careers available in tax practice. The career panels typically include three to four lawyers representing private practice, the government, academia, and one of the big four accounting firms. Panelists generally speak on how they pursued their careers, pitfalls they may have encountered, and any advice they may have for students interested in pursuing a career in tax law. A Q&A session concludes the panel, and participants then break for a networking reception, including light refreshments and drinks. Upcoming Careers in Tax Law panels include:

- February 2, 2012, University of Southern California Gould School of Law
- February 15, 2012, University San Diego School of Law
- March 1, 2012, The George Washington University Law School
- March 6, 2012, Boston University School of Law

For more information about the panels listed above or to organize one in your area, please contact Yolanda Lee at **yolanda.lee@americanbar.org** or 202-662-8680.

Careers in Tax Law Publication



An essential guide for anyone contemplating a career in tax, *Careers in Tax Law: Perspectives on the Tax Profession and What It Holds for You* is a compilation of essays written by over 75 tax professionals who share their unique perspectives, knowledge, and experiences. The Tax Section is pleased to offer a special ABA Law Student Division price of $25/copy.

For more information and to purchase a copy, go to **www.ambar.org/TaxPubs**.

Tax Section Job Locator Service

The Tax Section Job Locator program is intended to facilitate contact between U.S. law students and others interested in the practice of tax law and prospective employers interested in advertising tax law employment opportunities.

For more information, visit the Job Locator Service website: **http://www.ambar.org/taxjobs**.

It's Easy Listening This Winter with Tax Section Teleconference Recordings

If you missed last year's live programs, the following teleconference recordings and course materials are available through the ABA Web Store. For more information and to purchase, go to www.ShopABA.org and search by program title or product code.

Tax Traps and Opportunities in Buying and Selling a Business: Part I
(CETX0112T1CDR)

Tax Traps and Opportunities in Buying and Selling a Business: Part II
(CETX0112T2CDR)

The Codified Economic Substance Doctrine on Audit: Practitioners' Perspectives on the LB&I Examiner Guidelines
(CETX1011T1CDR)

Practical Problems and Practical Solutions for Private Foundations
(CETX0911T2CDR)

Drafting Real Estate Partnership and LLC Agreements
(CETX0911T1CDR)

Hot Topics in Renewable Energy
(CETX0711T1CDR)

The Move Towards "No Fault": The Accuracy Penalty Reconsidered
(CETX0611T3CDR)

Estate Planning in 2011 and 2012: The Aftermath of the 2010 Tax Act
(CETX0611T2CDR)

Ethical Issues When There Is a Personal Connection with a Client
(CETX0611SCDR)

Structuring Considerations in Light of *Canal*
(CETX0411T2CDR)

Installment Sale Acceleration and Unwinding Installment Sales – What Works and What Doesn't?
(CETX0411T1CDR)

Series LLCs. No, It's Not a New TV Series
(CETX0311T3CDR)

Consolidated Tax Return Basics
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Tax Implications of Dodd-Frank: Swaps, Futures, Forwards and Other Derivatives
(CETX0311T1CDR)

Current Developments in Individual, Corporate, and Partnership Taxation
(CETX0111TCDR)

Moving Forward (Two Years at a Time) with Estate Planning Under the 2010 Act
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Find out more and order online at www.ShopABA.org

Update Your Tax Law Library for 2012 with These Bestsellers from the Tax Section

A Practitioner's Guide to Innocent Spouse Relief

Thousands of Innocent Spouse claims are filed each year—this comprehensive and concisely written guide provides you with the framework for representing your client successfully. In straightforward language, the Guide takes you step-by-step through the Innocent Spouse claim process.

Product Code: 5470760
ISBN: 978-1-61632-847-4
Publication Date: May 2011
Section Member Price: $79.95

Effectively Representing Your Client Before the IRS

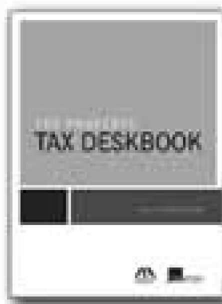
A comprehensive collection of everything a tax professional should know when dealing with the IRS written by some of the most experienced tax controversy lawyers in the United States. The two-volume reference also includes a companion CD-ROM featuring a searchable copy of the book and bonus content from Tax Section Meetings.

Product Code: 5470778
ISBN: 978-1-61438-134-1
Publication Date: December 2011
Section Member Price: $225.00

Sales & Use Tax Deskbook

All of the information tax managers, attorneys, and accountants are most likely to need about state sales/use taxes. Chapters are organized by state in a uniform format to aid in quickly and easily finding guidance on particular issues and to facilitate multi-state research. The volume includes a searchable CD-ROM.

Product Code: 5470761
ISBN: 978-1-61632-982-2
Publication Date: May 2011
Section Member Price: $225.00



The Property Tax Deskbook

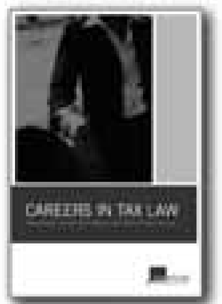
All of the information that tax managers, attorneys, and accountants are most likely to need about property taxes. Organized by state, each chapter is written each year by some of the most experienced property tax practitioners in that state. The volume includes a searchable CD-ROM.

Product Code: 5470777
ISBN: 978-1-61438-062-7
Publication Date: August 2011
Section Member Price: $225.00

The Supreme Court's Federal Tax Jurisprudence

Using the federal tax opinions of the United States Supreme Court as its primary guide, this book analyzes how federal tax laws have been applied in practice, with special emphasis on statutory interpretation and fact finding.

Product Code: 5470744
ISBN: 978-1-60442-756-1
Publication Date: June 2010
Section Member Price: $125.00



Careers in Tax Law: Perspectives on the Tax Profession and What It Holds for You

Designed for those considering or beginning a career in tax law, this informative guide presents a series of offerings—autobiographies in miniature—by a broad cross section of working tax professionals.

Product Code: 5470719
ISBN: 978-1-60442-235-1
Publication Date: April 2009
Section Member Price: $55.00

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ABA Section of Taxation CLE Calendar

www.americanbar.org/groups/taxation/events_cle.html

DATE	PROGRAM	CONTACT INFO
February 1, 2012	**Representing Your Client Before the U.S. Tax Court** CLE Teleconference and Live Audio Webcast	Tax Section www.americanbar.org/tax 202.662.8670
February 29, 2012	**Recent Amendments to Circular 230 and Their Potential Impact on Practitioner Disciplinary Proceedings** CLE Teleconference and Live Audio Webcast	Tax Section www.americanbar.org/tax 202.662.8670
March 19-23, 2012	**2012 ABA/IPT Advanced Tax Seminars** The Ritz-Carlton New Orleans – New Orleans, LA	Tax Section www.americanbar.org/tax 202.662.8670
March 28-30, 2012	**ALI-ABA Course of Study: Corporate Taxation** Pillsbury Winthrop Shaw Pittman LLP – Washington, DC	ALI-ABA www.ali-aba.org 800.CLE.NEWS
March 28-30, 2012	**12th Annual Tax Planning Strategies – U.S. and Europe** Hofburg Congress Center – Vienna, Austria	Tax Section www.americanbar.org/tax 202.662.8670
April 12-13, 2012	**ALI-ABA Course of Study: Charitable Giving Techniques** Millennium Knickerbocker – Chicago, IL	ALI-ABA www.ali-aba.org 800.CLE.NEWS
June 13-15, 2012	**5th Annual U.S. – Latin American Tax Planning Strategies Conference** Mandarin Oriental Hotel – Miami, FL	Tax Section www.americanbar.org/tax 202.662.8670

Thank You

The Section of Taxation thanks Bingham McCutchen LLP for its generous support of the Low Income Taxpayer Representation Workshop and Reception held in Washington, DC, on December 12, 2011.

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For more information about the Workshop or Tax Section sponsorship opportunities, call 202/662-8670 or send your inquiry to **taxmem@americanbar.org**.

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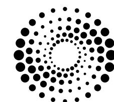

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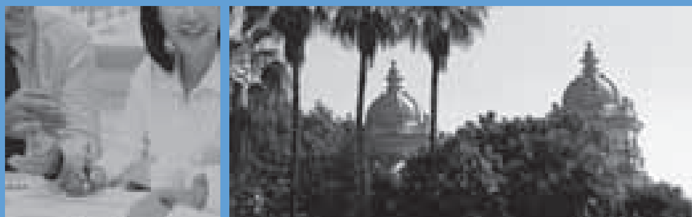

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Section Program: Current Developments in Individual, Corporate, Partnership and Estate & Gift Taxation

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http://meetings.abanet.org/meeting/tax/MID12/

HON. DAVID M. WALKER, *Founder and CEO of the Comeback America Initiative* and *former Comptroller General of the U.S.* will be the Keynote Speaker at the Plenary Session Luncheon, Saturday, February 18, 12:00PM – 1:30PM.

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