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Section of Taxation
NEWSQUARTERLY

POINT & COUNTERPOINT

Tax Incentives for Homeownership —A Lincoln–Douglas Debate

For its program at the Section's Fall Meeting, the Teaching Taxation Committee decided to depart from the typical panel format and experiment with its own version of a point-counterpoint. With talk of tax reform in the air—and a particular focus on reforming tax expenditures—the Committee recruited a group of debaters to engage in a Lincoln–Douglas style debate regarding the repeal of the tax incentives for homeownership. The debate proved both entertaining and informative. At Gail Richmond's invitation, our debaters have reprised their pro and con arguments on this topic for the readers of the *NewsQuarterly*. — *Anthony C. Infanti, Associate Dean for Academic Affairs and Professor of Law, University of Pittsburgh School of Law, Pittsburgh, PA*

The Tax System Should Be Neutral with Respect to Homeownership

By Neil H. Buchanan*

Nearly everyone in the United States, it seems, believes that home ownership is an essential part of the middle class experience. The American Dream, we are told over and over again, is incomplete until one buys one's own home and is paying a mortgage, rather than merely "throwing money away" on rent every month. The mythology has it that homeowners live in more stable neighborhoods, engage more fully in their communities, and build equity in support of their future financial security. Why would we *not* want to build into our tax system incentives to bring about all of those good things?

The answer, of course, is that none of those claims is actually true. While it *is* true that neighborhoods in which people own their houses are generally more stable than rental neighborhoods, and that the people living in owner-occupied houses are often more engaged with their communities than are people who live in rental housing, that does not prove cause and effect. Because "being a grownup" in this country supposedly requires a person to own a house, most people who are at the stage in life when they want to be a member of the PTA, or simply to live in one place for a longer period of time, have been convinced that the only way to do so is to own a house. The causation, therefore, runs not from home ownership to stability and community, but from stability and community to home ownership.

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Date	Meeting	Location
May 9–11, 2013	MAY MEETING	Grand Hyatt — Washington, DC
September 19–21, 2013	JOINT FALL CLE MEETING	Hyatt Regency — San Francisco, CA
January 23–25, 2014	MIDYEAR MEETING	Arizona Biltmore Resort & Spa — Phoenix, AZ
May 8–10, 2014	MAY MEETING	Grand Hyatt — Washington, DC
September 17–19, 2014	JOINT FALL CLE MEETING	Sheraton Downtown — Denver, CO

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From the Chair

By Rudolph R. Ramelli*

Boston proved to be a great location for the Section's Joint CLE Meeting with the Real Property, Trust and Estate Section. While the hotel was a little bit out of the way from most of the Boston attractions, the facilities and the Boston weather made up for any inconvenience. We had 1,057 registrants at the meeting, which was an increase from our normal fall attendance.

The Section's Committees put on approximately 120 CLE panels with ten joint panels presented with RPTE Committees. The materials produced at the meeting are available to Section members on Tax IQ, the Section's meeting materials database at www.ambar.org/taxiq. Tax IQ is a resource that the Section provides as a member benefit. I encourage you to take advantage of the great work our members provide to the Section.

The highlight of the Boston meeting was the appearance of Commissioner Shulman at the Plenary Session lunch on Saturday. As you know, Commissioner Shulman finished his term as Commissioner in November of this year. The Commissioner used his time with the Section to recount what he felt were the significant accomplishments during his term. The list of accomplishments was truly impressive, and it was rewarding to see that the Section was involved in many of the items the Commissioner mentioned. During the Commissioner's five-year term, the Section and the Commissioner's office developed a relationship of mutual respect and cooperation—a relationship that is good for the tax system. We thank Commissioner Shulman for his service to the tax system. The Section looks forward to working with the Acting Commissioner and the new Commissioner upon his or her selection.

One of the things that often accompanies Section meetings is the release of significant guidance from Treasury and the Internal Revenue Service. At the beginning of the meeting in Boston, Treasury and the Service announced their intention to amend Circular 230 dealing with the governance of practice before the Service. The proposed amendments would eliminate from Circular 230 the covered opinion standards in current Section 10.35. In lieu of the covered opinion, Section 10.37 would be expanded and enhanced to deal with all written tax advice. The proposed amendments would also add a new Section 10.35 setting forth standards regarding practitioner competence. In addition, the proposals would withdraw the proposed amendments to Section 10.39 governing state and local bond opinions. Those opinions would instead be subject to the enhanced standards in revised Section 10.37. Finally, the ever-present "Circular 230 Disclaimer" would no longer be necessary.

Circular 230 affects all tax practitioners. As a result, the Section has been very involved as Circular 230 has evolved over the past ten years. Numerous comments have been submitted by the Section as proposals were presented, and Section programs have dealt with Circular 230 issues.

On November 27, 2012, the Section submitted a comprehensive set of comments on the proposed amendments to Circular 230. In those comments, the Section commended the Treasury and the Service for the changes proposed and recommended a number of items for consideration. The Section's Midyear Meeting in Orlando will offer an opportunity for our members and the government to further discuss these significant changes to Circular 230. I encourage you to read the comments, which are available on the Section's website at www.americanbar.org/tax.

In addition to the comments on the proposed changes to Circular 230, comments were submitted by the Employee Benefits Committee dealing with the definition of a fiduciary under ERISA.

As I write this message, the Section's Midyear Meeting is just over a month away. In the brief time between now and when we meet, the country will have either fallen off the "fiscal cliff," reached a compromise to delay the events, or started to resolve the political and ideological issues that have led us to this point. In any event, the impact on our members will be significant. Many of our members have been working to close transactions and accomplish planning initiatives in 2012 under the existing tax regime. Our meeting in Orlando will serve as a good opportunity to take stock of where we are in the ever-changing world of providing tax advice and to discuss with other practitioners how best to serve our clients. I am looking forward to seeing many of you there. ■

* Jones, Walker, Waechter, Poitevent, Carrere & Denegre, LLP, New Orleans, LA.

INTERVIEW

R.J. Ruble

By Jasper L. Cummings, Jr.*

R.J. Ruble is currently living at the United States Penitentiary located at Lewisburg Pennsylvania, in the satellite prison camp houses for minimum security male offenders. He previously practiced law with Sidley Austin Brown & Wood. His conviction related to legal advice concerning "tax shelters." This interview was conducted by correspondence.

Q How long have you been at Lewisburg, when is your sentence up, and for what were you convicted?

A I've been at Lewisburg for nine months now [as of September 2012]. My sentence was 78 months long. There is no parole in the federal system; however, with "good time" I'll serve approximately 68 months. It is possible to be assigned to a half-way house or home confinement for the last 6 months of a sentence of this length.

I was convicted of defrauding the government in connection with tax opinions that I wrote for clients. I was also convicted of personal tax fraud. The terms of both sentences run concurrently.

Q How many other attorneys are currently in prison as a result of similar convictions? Do you have a sense of the impact of your or their convictions on the tax practice? In other words, do you think deterrence works in this area?

A While there are a number of attorneys here, I'm unaware of any other tax attorneys or any other attorneys convicted of defrauding the government as I was. I say that I am unaware, because etiquette here involves not enquiring of your fellow inmates' offences in too much detail. At times someone will volunteer information, but it is considered improper (and in some cases unwise) to ask for too much detail about why people are here. On the other hand, inmates are quite open about the length of their sentences (their "bids"). Inmates with longer bids are less inclined to bond with those having shorter bids.

As to the deterrent effect of my conviction, I believe that that is best answered by those who are practicing. I also believe that deterrence was part of the thinking in my prosecution. I think most of us recognize that the government does not have the resources to deal with the large number of cases it would otherwise have to handle if it couldn't rely on things like setting examples of bad actors and amnesty programs.

Q How does being a lawyer impact your experience in prison? Do you see the function of prison any differently than the other prisoners? Do you get a lot of requests for legal advice?

A Prison, even a minimum security prison camp like Lewisburg, is a different world from the "outside." Outside skills are not always that useful here, and many here do not hold lawyers in high regard. In fact, some of the best prison "lawyers" were never lawyers on the outside. They schooled themselves in the law out of necessity because they did not have the financial resources to hire a lawyer and had to pursue their defenses pro se. They also have more "cred" with the other inmates.

The other issue that lawyers here face in providing legal advice is that it is against prison rules to provide a service for compensation. If a former lawyer is found to have given legal advice to a fellow inmate, there is an assumption that it must be in exchange for compensation and the penalties can be severe.

There are times though when an inmate is just looking for someone to give sound advice; perhaps about what to do when he gets out or how to deal with an issue with prison administration, another inmate, or family. In those cases an inmate will often seek out some of us who were professionals on the outside for guidance. They may not hold lawyers in high regard, but some of the inmates are smart enough to know what they don't know, and for many of them how to deal with society on the outside is one of those things.

Perhaps now is the point to note that only a small proportion of those at Lewisburg are "white collar" criminals. Federal prison camps are supposed to be for non-violent offenders having sentences of ten years or less, so here we have a large number of folks convicted of drug related crimes or immigration offenses, particularly hiring undocumented aliens. It may also be the time to point out that it appears that more than 50% have not graduated from high school. While many on the outside hold the impression that a prison camp is a government-funded spa for high flying white collar types, the truth of the matter is that it is just the place where they dump short-term (ten years—short term? Hmm…) nonviolent offenders of all stripes.

Q Do you still like the tax law? Do you try to follow developments?

A Other than not being able to be with my loved ones, not being able to practice tax law is the thing that troubles me the most. However, it is not

* Alston & Bird LLP, Washington, DC, and Raleigh, NC.

possible to stay current; the resources are not available. The best I can do is follow what's published in the Wall Street Journal, which is never precise or accurate enough. Consequently, I've made the decision not to regret the loss of my professional life, but to focus my energies elsewhere. Here I'm focused on teaching. I teach a class for English as a second language and tutor inmates seeking their GED. I try to put the same kind of energy into that as I had put into my practice, and I am beginning to reap similar satisfaction.

Those here who hang on to what they were on the outside have the most difficulty adjusting. Many of us became so wrapped up in our work that we were what we did. Here, we can't do what we did, so we have to make a choice: hang on to what is no longer possible or adapt and move forward. Those who adapt and move forward get through their days in a healthier way.

The difficulty then becomes how to adapt when we get out. For me that's not an immediate problem, but those nearing their "out date" wrestle with it constantly. Many of the white collar guys were in professions that have licensing requirements (lawyers, accountants, doctors, pharmacists), and they will no longer be able to return to those professions because felons are barred from practicing in virtually all of them. In many cases this means that one of tools that was most valuable and productive, our training, is no longer of use. For many, it's a terrible thing to know that when you finally do get out all your years of training are worthless.

Q How did you get into tax work and did your practice change over the years?

A I got into tax law because I didn't want to take a Friday course in my second year of law school. My choices were a Tax 1 class that met on Thursdays or a commercial contracts class that met on Fridays. I had no other Friday classes and decided that as boring as I imagined the tax class would be, I'd be compensated with a three day weekend. By the time I finished my first day of tax, I was in love.

My practice had always had a strong cross-border element to it, and for most of my career that was its focus. As you know, much of that involved tax minimization and tax arbitrage planning, so trying to help clients reduce their tax burden was fairly second nature. By the mid-to-late '90s there was a strong emphasis on corporate and individual tax shelter work, and I slid into that almost as a matter of course, as did others with whom I worked. What may be lost on many is that throughout that period, I continued to do traditional cross-border tax planning.

Q I know you spoke at tax CLE programs because you and I were on a PLI panel in the late 1990s. What were the subjects you spoke on most and what was your message then?

A When I was fortunate enough to speak at CLE programs, I spoke about the very difficult conflict tax lawyers face in balancing their clients' interests versus the "tax system." I have always been an outspoken advocate of putting your clients' interests first. Nothing that has happened to me has changed my view. In fact, if anything, it has strengthened it.

The scales are very unbalanced when a client finds itself in conflict with the government. For better or worse, our legal system is based upon conflict—the rights of one party versus the rights of another fought out in negotiation and, ultimately, the courts. If the client's advocate does not forcefully and unequivocally represent him, the system does not work the way it's intended to. I've always found that the government tries to unbalance the scales in its favor as much as it can, and if the client's advocate isn't willing to represent his client to the fullest, there is no way the client will achieve a fair result.

Q The IRS recently has proposed a dramatic change to the "covered opinion" regulations, which basically will eliminate the separate rules for "covered opinions" and generally just require "reasonableness." What do you think of that?

A As I stated above, I no longer follow developments, and so I can't answer this one knowledgably.

Q Is there anything else you would like your fellow tax attorneys to know about being a lawyer in prison?

A Once you're in prison, it doesn't matter what you did on the outside, and the skills you had may not be particularly useful in a prison environment. It's a very humbling experience. I think that, as with all things in life, you need to be reflective about how you live your life from day to day, to decide what you can do that gives you satisfaction, and to move forward as best you can. For those who have friends or acquaintances inside, realize that for those of us here any positive connection with those on the outside makes life here much more tolerable, and that what may seem as a small act of kindness becomes magnified many times over to the recipient. ■

Income Tax Deduction and Deferral Strategies for Trial Attorney Contingency Fee Income

Part 2—Closely Held Insurance Companies

By Gerald R. Nowotny*

Overview

Part 1 of this series, which appeared in the Summer 2012 issue, examined the use of private placement variable deferred annuities in lieu of fixed annuities for structured settlement payments to trial attorneys. Part 2 focuses on the use of closely held insurance companies to provide tax reduction and deferral for contingency fee income.

Trial attorneys representing plaintiffs are among the mostly highly compensated professionals in our Society. They are also very entrepreneurial from both a legal and financial perspective. The majority of their income is from contingency fees—30%–40% in most cases—but they are compensated only if they win a jury verdict or favorably settle the case for the plaintiff. Some cases take years to settle, and the financial investment of the law firm in expert witness expenses is significant. In the aggregate, trial lawyers nationally earn $50–$70 billion per year. Ibbotson Associates Survey on Structured Settlement Annuity Market, 2007. They often have "spiked" income events as a result of a settlement or jury verdict every two–three years.

Many successful trial attorneys also own other businesses outside of the law firm. Many of these businesses are successful in generating additional income as well and become valuable assets on the trial attorney's balance sheet.

Trial attorneys are limited in their ability to reduce and defer taxable income. For example, a defined contribution plan has a contribution limit of $50,000 in 2012 and a salary cap of $250,000. Notice 2011-90, 2011-2 C.B. 791. Most trial attorneys have not utilized structured settlement annuities, which are conservative fixed deferred annuity products issued by large life insurers. The trial attorney forfeits investment control and flexibility through the structured settlement annuity purchase.

What Is a Closely Held Insurance Company?

A closely held insurance company (captive insurer) is an actual insurance company or reinsurance company with reserves for claims, surplus, policies, policyholders, and claims. Its main purpose is to insure the risks of the operating companies that are owned by the captive's owner, the trial attorney.

Traditional captive insurers have been primarily viewed as a means to reduce insurance costs or provide coverage not available in the commercial marketplace. The focus of the captive insurer for the trial attorney is to insure the underinsured and uninsured property and casualty risks of the law firm and of other businesses owned by the trial attorney. The captive insurer may also serve as a multi-line insurer, *i.e.*, an insurer that insures property and casualty risks as well as issuing annuities and life insurance.

Taxation of Closely Held Insurance Companies

Small insurers (life or property and casualty) receive preferential tax treatment in the Code. For example, an insurer can take a tax deduction for contributions to its reserves, its actuarial determination of future claims.

Some captives are able to make an election under section 501(c)(15) to be treated as tax-exempt organizations. These captives must have no more than $600,000 in gross receipts, and more than 50% must be from insurance premiums. Because of tax abuse of these captives, Congress has created more stringent requirements to meet the requirements for tax-free status. However, in the context of the trial attorney law firm, this election may be viable due to the ability of each firm partner to own his or her own captive cell, which is treated as an insurance company. Each captive cell in turn underwrites risks for the law firm.

An election under section 831(b) is an option for slightly larger captives, with a limit on premiums of $1.2 million of premiums annually. The captive is taxed on its investment income but not on premium income. Many partners will be able to qualify for the section 831(b) election. Premium payments in excess of this limit are not problematic. The captive can manage its reserves and timing of income. A section 831(b) election can be made as assets are released and become taxable to the captive.

As noted above, a captive may also be structured as a multi-line insurer. The small life insurance company provisions in section 806 provide a special tax deduction of 60% of life insurance taxable income. Section 816 requires that the company's reserves related to life and health insurance

* Long Gray Line Consulting, LLC, Avon, CT.

exceed 50% of total reserves of the insurer. The company cannot have more than $500 million in assets, and the deduction phases out when life insurance taxable income exceeds $3 million. The special provisions provide the company with an effective federal tax rate of 15%.

In order to be treated as an insurance company for federal tax purposes, the captive insurer must have a certain percentage of unrelated risks. The federal safe harbor is 50%. Rev. Rul. 2002-89, 2002-2 C.B. The amount of unrelated risk in case law is 30%. *Gulf Oil Corp v. Commissioner*, 914 F.2d 396 (3d Cir. 1990).

Basic Strategy

The law firm partners will form a closely held insurance company as a property and casualty company or small life insurer operating as a multi-line insurer. The company will be formed in an offshore jurisdiction in the British Virgin Islands and make an election to be treated as a U.S. taxpayer. The offshore domiciles are among the most highly flexible domiciles from an investment standpoint and allow the trial attorney to invest all or most of the company's assets with existing investment advisors. The shares of the insurance company may be owned outside of the partners' taxable estates for estate tax purposes.

The company will underwrite and issue low risk specialty property and casualty coverage for the law firm. These risks may include the following:

1. Business interruption
2. Reimbursement for time lost and out of pocket expenses incurred to support litigation
3. Loss of professional license
4. Uncollectible advances to clients
5. Unfavorable change in state or federal law
6. Computer technology and privacy problems

The law firm will pay tax-deductible premiums to the insurer. The premium payments will not be subject to gift taxes. Premium payments for excess disability coverage may be made on an after-tax basis so that any claim may be received tax-free. Company assets will be protected from the attorney's personal and business creditors.

The captive may also be licensed to issue life insurance and annuities in the jurisdiction. The insurer may also form an assignment company, allowing the issuance of structured settlement annuities that let partners defer the payment of contingency fees. As discussed in part 1 of this series, a trial attorney may agree in his fee agreement with the plaintiff to defer some or all of his contingency fees.

When settlement occurs, the fee obligation is transferred to an assignment company which is a wholly owned subsidiary of the life insurance company. The assignment company is the applicant, owner, and beneficiary of the annuity contract. It is a Barbados domiciled company in order to take advantage of the favorable annuity provisions of the U.S.–Barbados Income Tax Treaty.

The annuity contract contains traditional settlement options (life only, joint and last survivor) along with customized options for a specific payment date. The investment performance of the annuity contract is dictated by the investment performance of general account assets. The offshore life insurer has greater regulatory flexibility to consider a wider array of investment options.

Strategy Example

The Facts

Joe Smith, age 50, is a partner in a plaintiff's law firm. Joe has a professional corporation. He is married and has three children. He has accumulated $1 million in the firm's qualified retirement plans. His combined marginal tax bracket for federal, state and city purposes is 40%. His annual income after bonuses has averaged $3.5 million per year. Joe's lifestyle requires a net income of $500,000 per year.

Joe has a family trust that owns a $2.5 million life insurance policy on his life. He expects to earn an additional $5 million this year from a contingency fee on a medical malpractice case. Joe believes that he could make premium contributions to a captive insurer of $1 million per year for property and casualty insurance.

Joe plans to practice law until he is age 70. It is assumed that contingency fees of $2.5 million per year will be deferred each year with payments being guaranteed by Good Insurance's wholly owned assignment company.

The Strategy

Joe and the Smith Family Irrevocable Trust create a new insurance company, Good Insurance Ltd. (Good Insurance), that is licensed in Barbados. The company is capitalized with $250,000. The shares are owned by the Smith Family Trust, an irrevocable trust domiciled in Delaware. The company makes a section 953(d) election to be treated as a U.S. taxpayer for federal tax purposes.

Good Insurance will be licensed as a life insurance company and may offer property and casualty insurance as well. It will qualify as a small life insurance company under section 806(a) and will be exempt from taxes in Barbados. Good Insurance will also own an assignment company. Joe's investment advisor will manage captive investments to minimize current taxation.

Joe modifies his fee agreement with his client to provide for the deferral of any contingency fees. When the malpractice case settles, the assignment company enters into an agreement with the defendant to assume liability for payment of Joe's attorney's fees. The assignment company purchases a deferred fixed annuity from Good Insurance. The annuity provides for payments in four years, which is when Joe's daughter plans to enter college.

The annuity after that period will provide for life only payments beginning when Joe attains age 75.

Joe hires Good Captive Management (GCM) to perform a feasibility study for the captive and identify a portfolio of new coverage for the captive. GCM develops the policy forms and performs an actuarial review to determine the appropriate pricing. The projected premiums per year are $1 million.

Over the next five years, $5 million of income will be paid to the captive on a tax-deductible basis. The premium income will not be taxed. The captive's investment income will be taxed. The premium payments are not subject to gift taxes. The growth of Good Insurance, which is wholly owned by the Smith Family Irrevocable Trust will escape federal estate taxes.

When Joe is 70, the amount of accumulated deferred contingency income will be approximately $115 million, assuming an 8% rate of return. At age 79, the amount will have doubled, to $230 million. Joe has amassed a significant net worth independent of these deferred contingency fees. He elects to annuitize the annuity, selecting the life only option.

At Joe's death at age 82, the balance of the unrecovered annuity is not included in his taxable estate, thus producing estate tax savings in excess of $115 million. The unrecovered annuity balance is also not taxable for income tax purposes. The profit is captured within Good Insurance, which is owned in the family trust.

Summary

Nothing in the current landscape—economic or tax—suggests that plaintiff's attorneys will make less money due to tort reform or that taxes will be lower. The closely held insurance company strategy provides a unique approach to manage high taxation from contingency fee income. The captive insurer as a multi-line insurer provides a dual approach to reduce and defer current taxation. The insurer may underwrite underinsured or uninsured risks facing the trial lawyer and his firm. A captive insurer which is also licensed as a life insurer may issue structured settlement annuities.

The attorney's management control of the life insurer should provide a greater degree of incentive and confidence in the arrangement. Ultimately, significant estate tax savings can be achieved using a life only annuity payout. The unrecovered gain from the annuity payout reverts to the insurance company owned by the family trust as profit. The trial attorney defers taxation for decades, and the deferred income is transferred without estate taxation. ■

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PRO BONO MATTERS

"The Hardest Thing in the World to Understand Is the Income Tax." — Albert Einstein

By Francine J. Lipman*

There are almost 11 million working poor in America today. While this is the highest number since the Bureau of Labor Statistics started keeping track in 1987, it would be much higher if it included those unable to meet basic needs despite having an income just above the poverty threshold. And the child-poverty rate in America is higher than the same rate in Japan, Canada, or any European country except Romania.

America's most effective anti-poverty programs for working poor families are the earned income tax credit (EITC) and the child tax credit. These credits overwhelmingly lift millions of working poor families out of poverty. In 2010, working poor families received $55 billion in EITCs and $23 billion in child tax credits.

Notably, all of these life-changing refunds are paid only to those who file a tax return through the income tax system. As Albert Einstein has famously affirmed, the income tax system is enormously complex, especially for those without access to education, resources, or justice. America needs your help, and the Section is your vehicle to meet the exploding need for tax compliance and tax controversy assistance and to aid in the war on poverty. Laura Newland, the Section's new Pro Bono Counsel, has the passion, drive, and dedication to help us continue the Section's excellent good work assisting our underserved neighbors and community members with their tax matters.

In Her Own Words: Laura Newland, Pro Bono Counsel

After obtaining a degree in political science from Kalamazoo College in Michigan, I held a variety of public interest jobs, including working at a domestic violence shelter and a small jail-based voter education and registration nonprofit.

I decided to go to law school because of my interest in legal theory and also because, having worked with lawyers, I saw first-hand how powerful a law degree can be in advocacy work.

I must admit that taxation was the farthest subject from my mind when I started law school, but I found myself being drawn to tax once I realized the importance of the tax system in looking at issues such as income disparities, social programs, and taxpayer incentives.

The Section announced its Public Service Fellowship program around the same time that I was trying to figure out how to meld my new-found tax interest with a public service job. I applied for the fellowship during my last year of law school, which began my relationship with the Section.

The Section brought me to the Midyear Meeting after they awarded me the fellowship. I remember being pretty intimidated being around all the successful tax attorneys, but everyone I met was so great and welcoming. I am still impressed with how dedicated the membership is to serving low-income taxpayers and volunteering for pro bono work.

The Pro Bono and Tax Clinics Committee would like to expand the Calendar Call program to provide full coverage in every city that the Tax Court sits. We are also working on expanding our Adopt-A-Base Program, and there are lots of opportunities across the country for firms to Adopt-A-Base by training Military VITA volunteers on base.

I am very fortunate to be Pro Bono Counsel for the Section, which currently has a number of great pro bono programs, and the Pro Bono and Tax Clinics Committee is very active in promoting pro bono work. If any member has ideas for pro bono work that the Section is not currently involved with, I would love to hear from him/her. If someone is interested in a specific topic or specific population, please contact me or Keith Fogg, the Chair of the Pro Bono and Tax Clinics Committee, to discuss possible pro bono opportunities.

There is a great need for pro bono services (*e.g.*, immigrant/migrant tax issues, substantive military tax issues, tribal tax issues, access to tax services in rural areas, state and local tax issues, exempt organizations), so it's my goal to help meet that need through innovative program design. The prior Pro Bono Counsels have laid a strong foundation for me to build on, and I look forward to continuing to grow the Section's pro bono programming through the Pro Bono and Tax Clinics Committee. ■

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An Access to Justice Milestone

By T. Keith Fogg*

An important milestone in taxpayer access to justice occurred in October 2012. Low income tax clinics (LITCs) now have agreements with the Tax Court for every city in the country in which the Tax Court sits. This means that every pro se individual filing a Tax Court petition will receive correspondence from a tax clinic offering the opportunity of free legal services to assist in the resolution of his or her Tax Court matter.

As we approach the 50th anniversary of *Gideon v. Wainwright*, the pivotal case in establishing representation for criminal defendants, the existence of Tax Court agreements with clinics in all cities now allows civil tax cases to pass a milestone in access to justice for low income individuals.

Approximately 70% of petitioners to the Tax Court are pro se. Around 1980, the Tax Court began working with the early LITCs, all of which were academic clinics in law schools, to allow students to represent pro se taxpayers before the court. Gradually, that relationship expanded into more formal agreements through which the court notified pro se petitioners of the existence of clinics willing to represent low income taxpayers. The notification initially took place at the calendar call in cities where clinics existed and then moved to notification at the outset of the case. To formalize the agreement and assure a level of quality, the Tax Court eventually began entering into agreements with clinics; these agreements are renewed each year. If a clinic enters into an agreement with the Tax Court, the court will send a letter to pro se petitioners requesting place of trial in the city covered by the clinic. The notice to pro se taxpayers is a letter written by the clinic (or clinics) covering a specific city, which is placed in the envelope with the Tax Court's letter to the petitioner acknowledging receipt of the Tax Court petition. The letter is called a "stuffer notice."

Thanks to the efforts of Nina Olson and the late Janet Spragens (for whom the Tax Section renamed the Pro Bono Award in honor of her lifetime commitment to low income taxpayers), Congress created grant funds to assist in the development of LITCs. This funding caused clinics to grow from 16 in 1998, when the grant funds were created, to approximately 160 today. (For a comprehensive history of LITCs, see *History of Low-Income Taxpayer Clinics* at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2142144.) Thanks to the efforts of Chief Special Trial Judge Peter Panuthos over the past two decades and Chief Judge John Colvin during his tenure from 2008–2012, the Tax Court has engaged in significant efforts to assist the pro se taxpayers coming before it. Over the past several years, the number of clinics reaching an agreement with the Tax Court has grown until finally, in October 2012, full coverage of all cities was reached.

> Although an important milestone has been achieved, more can be done to assist *pro se* taxpayers—and the ABA Section of Taxation's Pro Bono and Tax Clinics Committee is leading the way.

Although an important milestone has been achieved, more can be done to assist pro se taxpayers—and the ABA Section of Taxation's Pro Bono and Tax Clinics Committee is leading the way. Most of the clinics representing low income taxpayers rely on local attorneys to accept pro bono cases to allow the clinics to provide representation for all of the clients seeking assistance.

Additionally, many low income taxpayers fail to obtain representation prior to the trial of their case despite the existence of stuffer notices. They arrive at the Tax Court calendar call in need of assistance. The Committee has worked with bar associations and LITCs around the country to set up Calendar Call programs to assist taxpayers at this critical juncture in their case. The Tax Court sits at more than 70 different locations across the United States, and there is a Calendar Call program in more than 60 of those locations.

If you would like to volunteer to assist in representing a low income taxpayer by working with a clinic on its pro bono panel of attorneys or by assisting at calendar call, please contact Tax Section Pro Bono Counsel Laura Newland at 202-442-3425 or by e-mail at laura.newland@americanbar.org. The Committee hopes that there can be 100% coverage of the Calendar Call program to match the success of the LITC agreements with the Tax Court. ■

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BOOK REVIEW

The Supreme Court, Federal Taxation, and the Constitution

By Jasper L. Cummings, Jr.

Reviewed by Gail Levin Richmond*

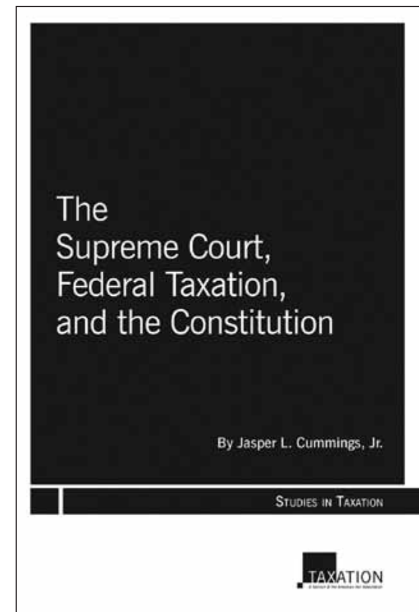
The Fall 2010 issue of *NewsQuarterly* included Peter Faber's review of an earlier book by Mr. Cummings, *The Supreme Court's Federal Tax Jurisprudence*. That book, a comprehensive review of more than 900 opinions, discusses changes in the Court's views of taxation and their effect on the development of tax law. Mr. Cummings' most recent book, *The Supreme Court, Federal Taxation, and the Constitution*, has a narrower focus. It reviews more than 1,100 opinions, beginning in 1796 with *Hylton v. United States* and ending in 2012 with *National Federation of Independent Businesses v. Sebelius*.

Mr. Cummings has organized *The Supreme Court, Federal Taxation, and the Constitution* for maximum accessibility. While lawyers, law professors, and law students are the most obvious audience for this book, they are by no means the only groups that will benefit from reading it. Scholars will appreciate the extensive footnoting, which includes references to primary and secondary authority. Social scientists (particularly historians and political scientists) will find a wealth of interesting background information about attacks on taxation in the 1890s through 1920s. They will not, however, find a blueprint for declaring most federal taxes unconstitutional. As Mr. Cummings notes: "… aside from certain targeted limits on federal taxation, such as the Export Clause, the willingness of the Court to rule for federal taxpayers on constitutional grounds is quite limited, though the potential is there, dependent largely on the Court's political leanings of the moment."

This book has many impressive features, beginning with its table of contents. Its more than 200 entries make it easy to find individual subtopics relating to the Constitution and tax issues. A reader who is interested in, for example, the uniformity requirement for duties, imposts, and excises, will find a listing for that topic and several subtopics.

The book begins with an introductory discussion of constitutional law. It then provides the text of each constitutional provision related to federal taxation. Mr. Cummings does not confine his coverage to specifically enumerated taxing powers and limits thereon. For example, there are sections dealing with the Supreme Court's tax decisions involving criminal constitutional law issues (including the Fourth Amendment, Eighth Amendment, and Double Jeopardy), First Amendment issues (e.g., speech, press, and religion), and separation of powers issues.

Mr. Cummings' treatment of the Court's 2012 opinion in *National Federation of Independent Business v. Sebelius* illustrates both the currency of this book and his ability to place the constitutional decisions into all relevant contexts. He extensively discusses this case in the "Taxes Versus Regulation" chapter, and integrates it into discussion throughout the book. A reader will encounter it in his discussions of such discrete topics as direct taxes, novel taxes, and taxes versus penalties.



Mr. Cummings provides comparable treatment for decisions in which the Court declared a federal tax provision unconstitutional. An early section of the book lists and briefly discusses all of these decisions. The decisions reappear at relevant points throughout the book. For example, *United States v. Butler* is included in the "Taxes Versus Regulation," "Direct Taxes and Other Taxes," and "Other Constitutional Issues" chapters.

The Supreme Court, Federal Taxation, and the Constitution is thoroughly researched, well-written, and a valuable addition to the literature. ■

To order a copy of *The Supreme Court, Federal Taxation, and the Constitution*, by Jasper L. Cummings, Jr., visit **www.shopABA.org**. The Tax Section member price is $125.

* Professor of Law, Nova Southeastern University Law Center, Davie, FL.

TAX BITES

Tax Bites Serenade

By Robert S. Steinberg*

I Hate Taxes

(To tune of "I Love Paris" by Cole Porter)

I hate taxes on my earnings.
I hate taxes on my haul.
I hate taxes on my profit in the market.
I hate taxes on the interest when I park it.

I hate taxes on my efforts —
On my sweat throughout the year.
I hate taxes.
Then, why, oh why, do I pay taxes?
The only reason is fear.

Smile NRA

(To the tune of "Smile" by Charles Chaplin (1936) with lyrics added in 1954 by John Turner & Geoffrey Parsons)

Smile, while we classify you.
Smile, though our laws shanghai you.
Just yesterday, NRA,
Not today.

You've been here too long without leaving,
Where dawdling leads to grieving,
When days above 182
Accrue.

Sore? No use in complaining,
Your CPA's explaining.
Now for returns, you must gear
Every year.

Paying tax on your world-wide income,
Taxed, feeling like a victim,
And watch your gift tax domicile,
But try to smile.

We Had A Good Run

(To the tune of "It Had to Be You" by Isham Jones & Gus Kahn)

We had a good run.
We had a good run.
That shelter we'd spun,
So brazenly done,
Had a good run.

We shoveled out trash,
And shoveled in cash.
From suckers with dough,
Who didn't know,
Greed leads to a crash.

Oh boy was it fun,
Intending no pun.
Our brains weren't taxed,
For tax savings maxed,
To levels that stun.

I'll never admit, at least not out loud,
From hypocrites, to steal made me proud.

We had a good run,
Son of a gun,
We had a good run.

Tax and Spending

(To the tune of "Love and Marriage" by Jimmy Van Heusen & Sammy Cahn)

Tax and Spending,
Tax and Spending,
Like a movie that seems never ending.
Raise a few more dollars,
And "Now let's spend it" someone hollers.

Tax and Spending,
Tax and Spending,
Leads to budget deficits ascending.
Argue let's be frugal,
Then someone blows the spending bugle.

Promote balancing the budget,
Be a good liar,
Then vote—Pass a bill to nudge debt
Yet even higher.

Tax and Spending,
Tax and Spending,
Talk of change is poppy-cock pretending.
Congress has no cheap seats,
So in the end,
The hogs un-penned
Will tax and spend away
To keep seats.

I Enjoy Reading the Code

(To tune of "I Enjoy Being a Girl," from the Rodgers and Hammerstein Broadway Musical "Flower Drum Song")

When I read a brand new section,
Feels like I've found the mother-load.
My smile has a wide inflection,
I enjoy reading the Code.

To structure a sly transaction,
That a tax trap might just explode,
The solving gives satisfaction,
I enjoy reading the Code.

At times I may cringe in desperate anguish
When a cross reference reaches a dead-end,
But then I discover wanted language,
And the IRC is once again a friend.

Though others enjoy good fiction,
Or a poem or a love-torn ode,
I savor the contradiction,
I enjoy being the one
Getting his (her) fun
From the Code. ■

* Law Offices of Robert S. Steinberg, Palmetto, FL.

A Law Student Perspective on Tax Law

By Tuan Ngo*

As a student of tax law, the last two years have provided me with a unique opportunity to examine the implications of tax policy. From the hard fought battle between the states and Amazon over whether out-of-state online retailers have to collect sales tax, to the ongoing national debate over tax cuts, to the discussion on whether to transform our international tax system by ending the deferral tax regime, these conversations have made at least one thing clear to me: tax is not merely an afterthought in policy discussions but in fact is a critical aspect of our democracy.

The recent election in California can be viewed through this lens. This past November, the people of California were faced with a decision at the poll to vote on whether to raise taxes to fund public schools and universities. Proposition 30 will raise sales tax by one penny for every $4 spent for four years and increase the income tax on California's highest earners for seven years. At stake for young voters and for Californians generally was nearly $6 billion in automatic spending cuts, falling almost entirely on public schools, if Proposition 30 had been defeated. Californians convincingly voted to support Proposition 30.

What makes the passage of this proposition such an important feat is that raising taxes in California is nearly impossible because California's tax system dramatically curtails lawmakers' ability and willingness to raise taxes. And so this voter-approved proposition signaled an awareness that in order to support an affordable and high-quality education, Californians must be willing to pay for it.

Like California, the U.S. Congress now debates tax reforms that include altering tax rates. The effect of Congress' decision, or indecision, will have a dramatic effect on businesses and Americans. Whether it be funding for education, or social security, at the root of these social policies is tax law.

As an aspiring tax attorney, being a part of the ABA Section of Taxation has allowed me to meet and learn from experts in the field about these challenging tax issues. As I prepare to attend the 2013 Midyear Meeting, January 24-26 in Orlando, Florida, I have high hopes to continue learning and networking with our country's leading attorneys and government officials to discuss the latest tax policies, initiatives, and regulations. ■

* Third Year at University of California, Hastings College of the Law, San Francisco, CA; ABA Law Student Division Liaison to the Section of Taxation.

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This difference is dramatically important, because we need to understand that we are currently unwisely basing our tax (and other) policies on the false idea that we can improve people's lives by pushing them to buy houses that they would be better off renting. The recent housing bust, with millions of homes lost to foreclosure, was a searing manifestation of the extreme harm caused by our decades-long efforts to push people into buying houses. Whereas every competent financial advisor would otherwise tell people to diversify their portfolios—to buy a "statistically independent" mix of stocks and bonds, from different issuers, and of different maturities and risk levels—we (through our policy choices) tell financially unsophisticated people to put all of their money into one big, risky asset. Why? Because "the great middle-class tax break" is the mortgage interest deduction (along with the deductibility of property taxes), which supposedly leaves people out in the cold if they do not get with the home-ownership program. The resulting tragedies, in which people dutifully bought their homes, only to lose everything in a crash caused by financial manipulation run amok, are sad testament to the foolishness (and worse) of our country's fetish with the mythical benefits of owning houses.

It is the position of the Affirmative team in this debate, therefore, that the tax system should be neutral with respect to home ownership. Note that we could actually have taken a still more aggressive position, which would be that we should actively *discourage* the ownership of houses, on the basis of prudent principles of financial diversification. We are, however, content to leave it to private individuals to decide whether to take the risks inherent in home ownership—but only in a world in which they are faced with the actual costs and benefits (and in which they are fully aware of the real risks) of owning houses.

Our argument goes beyond the diversification issue. As a general principle of taxation, it is a bad idea to give people incentives to do things that are not justified by some affirmative, defensible social goal. As noted above, the "stability and community" goals—as admirable and desirable as they may be—do not add up to a justification of mass home ownership. Moreover, every tax subsidy designed to encourage something must perforce discourage one or more other things. If we divert economic resources into housing—by giving people incentives not merely to own houses, but to live in larger and more wasteful spaces than they would otherwise be able to afford—then we deprive ourselves of the use of those resources for other purposes. Schools remain underfunded, roads and bridges remain (in the aggregate) more than two *trillion* dollars behind in dangerously neglected repairs nationwide, our electrical grid remains disastrously out of date, and a host of other problems remain unaddressed.

Note that this argument does not rely only upon the cost to the federal budget of these subsidies—although those costs are substantial; nor does it require one to believe that the proper goal of tax policy is the promotion of the economic concept of "Pareto efficiency." On the latter point, I have argued extensively elsewhere (and I am hardly alone in this claim) that the Pareto-efficiency concept is incoherent. Even if one disagrees with me on that point, however, it is possible for all of us to agree that it is a "waste," in a very meaningful sense of that word, to expend resources to induce people to make decisions that do not improve even their most immediate situations (compared to an achievable alternative). The costs of policies to encourage home ownership are simply too great, compared to any conceivable set of benefits (objective or subjective) that one could reasonably defend, for us to continue on our current path.

The costs that go beyond the budgetary impact include all of the physical assets and human talents that go into building larger homes, maintaining those homes through a crazy and chaotic mismatch of contractors and individual home owners, and selling and financing those houses through a process that is labor intensive and needlessly expensive. (Surely, every buyer and seller who has looked at his or her closing costs has marveled at the thousands of dollars of mysterious costs—title insurance, anyone?—that are attached to every transaction.) These are costs to the economy, in the very real sense that billions and even trillions of dollars worth of economic activity is misdirected into this long-term attempt to make everyone believe that life is not complete until one has his or her name on a title deed.

We on the Affirmative team are not, moreover, doctrinaire about how the United States should end its misbegotten (if honorable) experiment in mass home ownership. One route would be to tax the imputed value of owner-occupied homes. There is a very good argument in favor of making this change, along the same lines as the argument for taxing the premium values of employer-provided health insurance policies. Just because people do not think that they are receiving income does not make it so. We tax income from discharge of debt, too, even though that might not "feel" like income.

Such a change would, of course, require that the newly expanded definition of taxable income be properly computed, which would involve possibly significant administrative changes that would need to be coordinated and policed. (We do not, however, find it meaningful that there are other untaxed imputed values. The manifest damage that mass homeownership has visited upon the U.S. economy in the last several years—to say nothing of its ongoing costs—is simply too big to continue to tolerate. Not taxing the

implicit rental value of, say, cappuccino makers is hardly a reason to be "consistent"—that is, consistently wrong—regarding so massive a sector of the economy as housing.)

If it turns out that taxing the imputed value of owner-occupied housing is unacceptable, however, then the answer is not to give up, but to see if we can achieve the same goal from the other direction. That is where Professor Ventry's persuasive arguments in this debate, regarding the mortgage interest deduction, come in. The subsidy currently arises from our inconsistent tax treatment of the costs and benefits of home ownership, failing to tax the benefits while allowing deductions for the costs. Taking one consistent approach or the other is more important than arguing over which approach to take.

If we are going to move toward a consistently neutral approach to home ownership, however, it is essential to address the distributive aspects of the problem. Continuing on our current path, as Professor Ventry points out, showers tax benefits on upper-middle and upper income taxpayers, with little benefit to the vast majority of the population—even though many people have been induced to buy houses on the illusory claim that the tax benefits justify that decision. Therefore, if we cannot "level down," by discontinuing the tax subsidies for owning houses to everyone, then we should "level up," by expanding the subsidies so that everyone has equal access to them. Although doing so would increase some of the costs that accompany tax subsidies, it would spread those costs more appropriately.

Finally, we are fully aware that any changes to a system that affects so many people must be made carefully, with phase-in periods and transition rules that will allow the consequences of our policies to be borne by those making their choices prospectively, not principally by those who purchased homes in reliance on the social inducements to home ownership. Of course, any change has some effect on those who have already developed reliance interests. The best that we can do is to try to minimize those consequences.

In short, the tax system in the United States attempts to expand individual ownership of houses, even though there is no evidence that individual ownership is good for the country, and even though the costs of doing so are enormous and have caused financial ruin for many American families. It is time to change course.

Tax Neutrality for Housing: The MID and Section 121

By Dennis J. Ventry, Jr.*

Allowing tax offsets for the costs of homeownership make sense if we tax the imputed income from homeownership. But we don't. Thus, the deduction for mortgage interest (as well as the deduction for property taxes, the exclusion for gain upon sale of a principal residence, and other tax dispensations for owner-occupied housing) violates the fundamental principle of a net income tax. And while such violations of "pure" tax policy may fail to incite the electorate or legislators, a more provocative charge may perk a few more ears: the mortgage interest deduction (MID) is the most inequitable, inefficient, and ineffective of all tax expenditure items.

First, the MID is the classic upside down subsidy. It distributes benefits not to households on the margin between owning and renting but rather to those who would own homes with or without the subsidy. Of the $100 billion in tax revenues lost through the MID each year, taxpayers reporting income above $200,000 (less than 3% of all filers) enjoy 35% of the subsidy's tax savings, while taxpayers reporting income above $100,000 (roughly 12% of filers) capture nearly 80% of the MID largesse.

That leaves very little for everyone else. Taxpayers with income below $75,000—or 80% of filers—receive just 11% of the subsidy. So much for helping the middle class.

The primary reason for the maldistribution of MID benefits is the subsidy's delivery mechanism as an itemized deduction. Only one-third of all taxpayers itemize while the remaining two-thirds receive nothing from the MID. Moreover, high-income households claim a disproportionate share of itemized deductions: 15% of households with income below $50,000 report itemized deductions, compared to 96% with income above $200,000.

Only 25% of taxpayers claim the MID in any given year. Even for those taxpayers, the net benefit of the MID can be negligible. The "true" value of the MID is not the gross amount of interest paid, nor even that figure multiplied by the taxpayer's marginal tax rate, but rather the amount by which total itemized deductions exceed the standard deduction multiplied by the taxpayer's marginal tax rate. Thus, a taxpayer could be paying thousands of dollars in mortgage interest, but not enough to itemize or barely enough to deliver any tax benefits.

With respect to the MID's inefficiency, economists have long indicted the

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deduction for distorting the housing and mortgage markets.

First, it creates a false baseline for the cost of housing by encouraging taxpayers to pay for homes with debt rather than cash or financial assets. Thanks in large part to the MID, mortgage indebtedness soared in the decade preceding the most recent housing collapse, rising as a percentage of GDP from 47% in 1995 to 81% by 2007.

Second, it induces unproductive misallocation of both physical and financial capital. By creating artificial demand for owner-occupied housing through subsidized mortgage debt, the MID encourages homebuyers to purchase larger and more expensive homes than they would otherwise. And no wonder, the economy-wide tax rate on housing investment is close to zero, while the tax rate on, say, corporate investment exceeds 30%.

Third, the MID contributes to lower economic productivity, depressed real wages, labor immobility, and higher rates of unemployment.

All of this misguided demand raises aggregate housing prices between 3% and 10%. And while current homeowners may prefer inflated prices for maximizing gain upon sale, any perceived benefit is illusory as sellers become buyers in the same overheated market, to say nothing of millions of first-time homebuyers who are excluded from the market altogether.

If the MID actually helped taxpayers achieve homeownership, we might tolerate its gross inequity and destructive inefficiency. But substantial empirical research over the last 30 years has concluded that the MID has almost no effect on the rate of homeownership.

In the end, the Code's most sacred of all cows has no redeeming qualities. It is inequitable, inefficient, and ineffective. It is high time to put it out to pasture.

Section 121

The exclusion for gains from the sale of a principal residence shares many of the same destructive features as the MID. It is inequitable in that it disproportionately benefits high-income households. It is inefficient in that it creates overinvestment in housing. And it is expensive, costing roughly $25 billion annually in lost revenue. For these reasons alone, the exclusion should join the MID in the uncrowded pasture of discarded tax subsidies.

But it has additional features that merit its repeal, including: (1) compliance problems; (2) sheltering opportunities; and (3) a singles penalty.

In the end, the Code's most sacred of all cows has no redeeming qualities. It is inequitable, inefficient, and ineffective. It is high time to put it out to pasture.

First, when a taxpayer realizes gain from the sale of an owner-occupied residence, she is basically on the honor system. She is supposed to reflect gain on Schedule D and, in some instances, report income on Form 1099-S. However, taxpayers often lump gain from the sale of residences with gain from other sales on Schedule D, and taxpayers can meet the certification requirements for section 121 by merely saying as much.

In addition, it turns out that taxpayers report only a fraction of all sales of principal residences in any given year. A recent study found that for tax year 2007, taxpayers reported only 6.5% of all residential sales. Even for those reporting sales, it is clear that many of them are fudging the numbers. Of the 368,000 sales reported in 2007, 14% miraculously reflected a sales price that equaled basis. Gerald Auten & Jane G. Gravelle, *The Exclusion of Capital Gains on the Sale of Principal Residences: Policy Options*, in Proceedings of the 102nd Annual Conference on Taxation, 103, 105 (National Tax Association 2009).

Second, the section 121 exclusion helps taxpayers convert what amounts to ordinary income into excluded capital gain income. A good number of professional real estate investors buy homes, renovate them (and perhaps even occupy them), and then sell two years later, thereby creating untaxed labor income. Another sheltering technique involves purchasing a house sitting on substantial unimproved land that the taxpayer holds for investment. The taxpayer may sell the unimproved land without losing the exclusion so long as the taxpayer also sells the home within two years before or after the sale of the unimproved land.

Two more sheltering opportunities deserve mention. The first involves converting vacation homes into principal residences by living in the original home while also "living" in the vacation home, and then selling the vacation home after two years. The second scheme amounts to house swapping, whereby individuals sell homes back and forth to each other every two years, often never leaving the original home.

Third, section 121 provides differential benefits based on marriage, with single taxpayers receiving half the exclusion available to married couples ($250,000 versus $500,000). But the differential treatment ignores economies of scale and that married couples own houses less than double the size or double the cost of those owned by single taxpayers. The inequity exists for same-sex couples as well, a taxpaying cohort that is prohibited from receiving the $500,000 exclusion even if they are legally married or members of relationships granted legal status equivalent to different-sex married

couples (such as domestic partnerships or civil unions).

Two final thoughts. First, defenders of section 121 argue that repealing the subsidy would contribute to labor immobility due to lock-in effects, thus raising unemployment or underemployment. But we usually worry about lock-in when it is accompanied by a liquidity problem, and that is not the case for taxpayers with built-in gains. And since the tax rate on such gains is not confiscatory—far from it—the problem seems overstated. Second, some portion of gains on durable goods like principal residences is attributable to inflation. If we wanted to account for that inflation in the absence of section 121, we could tax real gains instead of nominal gains.

Conclusion

In conclusion, we need look no further than the "father" of the modern tax expenditure budget, Stanley Surrey, for the invocation of tax neutrality. Throughout his career, Surrey argued for an aggressive national housing policy for low- and middle-income Americans that delivered benefits not through the tax expenditure budget but through the direct expenditure budget. At the same time—and on the basis of equity, efficiency, and tax simplification—Surrey called for substantial increases in the standard deduction so that lower- and middle-income taxpayers could enjoy a zero-bracket on par with upper-income taxpayers. (Capping itemized deductions at a certain rate or an absolute dollar amount, a more recent policy proscription, could achieve similar goals while having the added benefit of raising rather than lowering revenues.)

Surrey's vision of a streamlined tax code charged tax policymakers and experts with evaluating and then reevaluating (1) whether a subsidy was necessary to influence behavior in the first place; (2) whether subsidies should be located in the tax system; (3) whether current subsidies were working as planned; and (4) whether we would be better off with fewer tax subsidies. Accordingly, and nearly 30 years after Surrey's death, there is no question that we would be better off without the MID and section 121, and, if design and administration permitted, *with* a tax on net imputed rental income.

Don't Tax Imputed Income from Owner-Occupied Houses

By Steve R. Johnson*

The United States should continue its historic practice of excluding from taxable income the imputed rental income of homeowners. Proposals to curtail the exclusion have often been entertained. Most recently, the Congressional Budget Office analyzed the possibility. *See* Larry Ozanne, Taxation of Owner-Occupied and Rental Housing, CBO Working Paper 2012-14 (Nov. 2012)(CBO Report).

The United States income tax has never reached imputed rental income. In the early 20th Century, several European countries did tax imputed rental income of owner-occupied housing. However, the practice has been abandoned in all but Belgium and the Netherlands. *See, e.g.,* Paul van den Noord, *Tax Incentives and House Price Volatility in the Euro Area: Theory and Evidence,* 101 Économie Internationale 29, 36 (2005).

In referring to the nontaxation of imputed rental income as an "exclusion," I use that term broadly. Narrowly, exclusions are Code sections that remove from taxability items that would be taxable taking into account only section 61. There is dicta in old cases to the effect that imputed rents are not within the compass of constitutional or statutory "income" in the first place. *Helvering v. Independent Life Ins. Co.*, 292 U.S. 371 (1934); *Morris v. Commissioner*, 9 B.T.A. 1273 (1928), *acq.* VII-2 C.B. 2 (1928). Most today would doubt the existence of a constitutional barrier, and there is no express statutory exclusion. So "[t]he exclusion is rather a matter of administrative practice, but no less firmly established for that reason." J. Martin Burke & Michael K. Friel, Taxation of Individual Income 28 (10th ed. 2012).

The discussion below acknowledges that there are revenue, equity, and efficiency arguments in favor of ending the exclusion but maintains that these arguments are trumped by considerations of administrability and political acceptability.

Arguments for Taxation

The exclusion has revenue implications, of course. The Treasury Department identifies the exclusion as a tax expenditure costing the federal fisc $50.6 billion in fiscal 2012, compared to $86.9 billion for the mortgage interest deduction, $16.2 billion for the property tax deduction, and $16.0 billion for the capital gains exclusion (the three other tax benefits to homeowners). Budget of the U.S. Government Fiscal Year 2013*, Analytical Perspectives* 250 (Office of Management and Budget 2012). The

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Joint Committee on Taxation, however, does not include the imputed income exclusion as a tax expenditure, believing it to be warranted by administrative necessity. *See* Joint Comm. on Tax'n, Estimates of Federal Tax Expenditures for Fiscal Years 2011–2015, JCS-1-12, at 6 (Jan. 17, 2012).

It is a matter of ideological preference (as to which, the recent election shows, the American public is divided) whether federal budget deficits are better addressed by tax increases or by spending reductions. Those who prefer the former must then consider which tax increases are best (or least harmful). The position of the Democratic Party in the recent election was that taxes on the rich should be raised so that tax increases on the middle class can be avoided. Taxing imputed rents would hit many more middle class Americans than rich Americans.

There are equity and efficiency dimensions to the debate as well. Assume that Evelyn owns a house. She could choose to rent the house out and to live in comparable rented premises. In that event, she would receive rental income taxable under section 61 and would incur rental expense nondeductible under section 262. Alternatively, Evelyn could choose to live in the house herself. In that case, she would have no taxable income and would pay no expense (leaving aside costs, such as property taxes, that Evelyn would incur under either alternative). In practical effect, Evelyn the owner-occupant would obtain the same rental value or income as would Evelyn the landlord, but that income would be taxed only in the landlord scenario.

The exclusion can bias economic choices and discriminate among arguably similarly situated persons. It advantages owner-occupants over landlords, owners over renters, and those who hold their wealth in the form of housing over those who hold it in investments yielding taxable returns.

Conceptually, there are reasons to think of imputed rental values as income. Under the formulation of public finance economists Georg Schanz, Robert Haig, and Henry Simons, income is the "sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question." Henry C. Simons, Personal Income Taxation 50 (1938). So defined, imputed rental values are income.

Owner-occupied houses are not the only assets or activities that generate imputed value. By the same economic logic, owning and using any other property—cars, boats, refrigerators, washer/driers, etc.—does so as well. So do self-performed services.…

Administrability

I was first exposed to taxing imputed rental income as a law student taking the introductory income tax course. My reaction was that the notion exalts theory over common sense and practicality. The more I have thought about it over the ensuing years, the more convinced I have become of that assessment.

Practicality implicates three of Adam Smith's four maxims and two of Henry George's four principles as to taxation. *See* Adam Smith, The Wealth of Nations 777–79 (Mod. Lib. 1937); Henry George, Progress and Poverty 414–18 (4th ed. 1929). Professor (later judge) Sneed identified practicality as one of the seven pervasive purposes which shape the rates and structure of the federal income tax. He saw practicality and equity as the two highest ranking of the seven macro-criteria and concluded: "Of the two, Practicality frequently must be granted more weight than Equity." Joseph T. Sneed, *The Criteria of Federal Income Tax Policy,* 17 Stan. L. Rev. 567, 601–02 (1965).

Numerous features of the Code reflect the judgment of Congress that, in the situation, theoretical perfection must yield to administrability, *e.g.,* sections 63(c), 102(c) & 152(e), and I have argued that conceptual purity should yield to administrability in even more contexts. *See* Steve R. Johnson, *The E.L. Wiegand Lecture: Administrability-Based Tax Simplification*, 4 Nev. L.J. 573, 582–84 (2004).

Virtually everyone would agree that the needs of administrability should control over equity and efficiency considerations in some situations of potential imputation. Owner-occupied houses are not the only assets or activities that generate imputed value. By the same economic logic, owning and using any other property—cars, boats, refrigerators, washer/driers, etc.—does so as well. So do self-performed services. Paint your own house, mow your own lawn, write your own will, and you have imputed services income in economists' eyes.

To tax imputed income from only owner-occupied houses (and not from other durables or from services) would leave some inequities and inefficiencies unaddressed. Indeed, if taxpayers truly are sensitive to such things, it might induce some to shift wealth from housing (the imputed values of which would be taxed) to other durables (the imputed values of which would not be taxed).

Nonetheless, virtually no one seriously proposes imputation taxation across the full spectrum of assets and activities. The administrative problems would be beyond comprehension, nightmarish. For this reason, proposals to tax imputed values nearly always are limited to owner-occupied homes.

Yet even in this limited context, the practicality problems strike me as more than should be borne. Taxing imputed income from owner-occupied houses would create serious problems of reporting and recordkeeping for taxpayers, enforcement for the Service, and valuation for taxpayers, the Service, and the courts.

The CBO describes the two methods used by countries that have taxed imputed rental income and the problems each entails. Under one method, the Service would assign each owner-occupied home a rental value reflecting rents being charged for similar homes. To produce parity with landlords, owners could deduct allowable costs (such as maintenance and operating expenses, mortgage interest payments, property taxes, and depreciation) to compute net rental income. This is the more precise of the two methods, "but is difficult to implement because it requires estimates of rental values for homes, complex recordkeeping by homeowners, and additional monitoring responsibilities for the Internal Revenue Service (IRS)." CBO Report at 28.

Under the second method, the Service would assign a rate of return to the value of each owner-occupied home equal to the return that would be earned on a savings account. Owners would be allowed to deduct mortgage interest paid (but not other expenses because the assigned return is the return on invested capital, not gross market rent). This alternative "requires less recordkeeping but would still require the IRS to take on more administrative responsibilities, such as verifying whether taxpayers owned or rented the home in which they reside and what they reported as house values." Moreover, "[t]his would be more challenging than verifying the current law deduction for mortgage interest because all filers—including those who do not currently itemize or who do not have mortgages on their home—would be affected." *Id.* at 28–29.

How would we determine the value of homes? Local property tax assessments are notoriously imprecise within jurisdictions. They also vary widely among jurisdictions, creating horizontal equity problems. Moreover, homeowners would have incentive to artificially depress values through creative, often collusive, temporal or spatial ownership split schemes. We have seen such schemes proliferate for estate and gift tax reduction purposes. Subjecting tens of millions of homeowners to income tax on their imputed rents would spawn a new dimension of tax sheltering.

Political Acceptability

Especially in a democracy, a tax regime lacking popular approval (or at least acceptance) is unlikely to stand for long. Taxing imputed rental income would be highly unpopular and perhaps politically unsustainable.

"The concept of imputed income is often difficult to grasp." Burke & Friel, *supra,* at 27. Indeed. View the matter through the eyes of an average homeowner, and the potential for confusion and resentment is obvious. "It's my house. I bought it with already taxed money. You mean I'm now going to be taxed on income I never saw but which some egghead economist or bureaucrat theorizes I got!?" The countless taxpayers whose homes are now "underwater" would find this a particularly bitter pill to swallow.

Judges, even some tax specialist judges, have found imputed income problematic. *E.g., Independent Life Ins. Co., supra*, 292 U.S. at 379 ("The rental value of the building used by the owner does not constitute income within the meaning of the Sixteenth Amendment."); *Morris, supra,* 9 B.T.A. at 1278 ("the rental value of a private residence … has never been regarded as income"). If jurists find the idea of imputed income difficult to credit, taxpayers can hardly be expected to understand and embrace it.

Another experience also points in this direction. The Treasury does include some imputed income in "family economic income," a concept it uses in assessing the distribution of tax impacts on persons at different income levels. "But even this limited use of imputed income is not well understood by the media, politicians, or the public." Michael J. Graetz & Deborah H. Schenk, FEDERAL INCOME TAXATION PRINCIPLES AND POLICIES 133 (6th ed. 2009).

Taxation of imputed rental income would be intensely unpopular and would be viewed as unfair. *See id.* at 131 (questioning "the political wisdom of a rule [taxing imputed income] that no one would understand or accept"). Were the reaction large enough, this could pollute public attitudes towards the Code generally, a risky proposition in a system, like ours, marked by low audit rates and dependent on voluntary compliance.

Conclusion

Theoretical models are entitled to respect, but, for administrability, political acceptability, and other reasons, every income tax on the planet departs in significant respects from the Schanz-Haig-Simons formulation. For over a century, the Supreme Court has emphasized that "[t]axation is eminently practical." *Nicol v. Ames,* 173 U.S. 509, 516 (1899). Similarly, in a constitutional context, Chief Justice Roberts observed: "To an economist, perhaps, there is no difference between activity and inactivity…. But the distinction … would not have been lost on the Framers who … were not mere visionaries, toying with speculations or theories, but practical men, dealing with the facts of political life." *National Fed. of Independent Bus. v. Sebelius*, 132 S. Ct. 2566, 2589 (2012) (punctuation and citations omitted). The same should be true, I submit, for the men and women who design our tax rules. There are arguments in favor of taxing imputed rental income. Ultimately, though, those arguments are trumped by the practical imperatives of operating an administrable and politically acceptable tax system.

We Should Continue to Provide a Tax Break for Gains on the Sale of Owner-Occupied Houses

By N. Harold Buchanan

The arguments regarding individual home ownership, which Professor Neil H. Buchanan (my alter ego) laid out in his Affirmative comments, may or may not be persuasive. I will leave that for others to decide. Here, I will argue that—even if we are going to change the tax and other policies by which we encourage people to own the houses in which they live—the most defensible of those many subsidies is the exclusion of any gains that are realized when people sell their houses. If we are to eliminate that subsidy, we should do so very carefully indeed—and only after eliminating all other subsidies.

Few people could defend the details of the current version of section 121. I certainly cannot do so. Its provisions are the result of a collection of arbitrary line-drawing exercises, which cumulatively open up the usual opportunities for abuse and avoidance. Why do we allow people to aggregate any number of non-contiguous days of ownership and use of a house, adding up to two years out of five? Why, in fact, did Congress choose those particular numbers? Why do valid excuses for the rapid sale of a house (change in employment, health, or unforeseen circumstances) make the taxpayer eligible for only a proportionate amount of the maximum exclusion of gains, not the full amount? Why is that maximum exclusion not indexed to inflation, or adjusted for local differences in real estate prices?

There are no easy, or satisfactory, answers to those questions. Any real-world policy is going to require anti-abuse provisions, and those provisions themselves almost always open up other avenues of abuse. Even so, the effort to provide rough justice is worth the legislating and enforcement costs, and the ongoing efforts to refine the policy, if they serve an important purpose.

What, in fact, is the purpose of the exclusion from gross income of gains on the sale of a home? Now-repealed section 1034 provided a life-long incentive to use owner-occupied houses as savings vehicles. So long as the taxpayers lived in a house that they owned, they were (given that ours is a realization-based income tax) not subject to taxation on any gains. Because Congress was aware that people with growing families would need more space as young ones were added to the brood, section 1034 made it possible to "buy up" to more spacious houses, without paying taxes on any gains. After the taxpayer reached age 65 (lowered to 55 in 1978 legislation), when the children presumably had left the parents in an empty nest, a one-time exclusion was allowed in an amount ($125,000 in 1997) that was almost sure to be large enough to allow all of the nest egg to be left untaxed. Until section 1034 was repealed in 1997, taxpayers who qualified could exclude gain under section 121 and use section 1034 to defer recognition of excess gain—if they purchased a replacement residence.

Why did we change from this lifecycle-based approach to our current haphazard two-of-five-years system? One reason could be that the perverse incentives in section 1034 were even worse than those in section 121, because the older provision encouraged people—even people who were not moving for the purpose of adding to the size of the family—to buy ever-more-expensive homes. For moves from a more expensive to a less expensive city, the incentives were especially odd, with the requirement to buy a more expensive house causing middle-class families to buy pointlessly large replacement homes. Moreover, stories of "55th Birthday Sales" were often heard, as people sat for years in houses, simply waiting for the moment when they could cash out tax-free.

Therefore, although section 121 surely includes an array of provisions that can charitably be called quirky, it does at least get rid of the especially perverse incentives that were necessarily part of the "Ozzie and Harriet"-based worldview embodied in section 1034. If we are going to continue to allow people to use their houses as tax-free savings vehicles, then we should try to improve those provisions, understanding that any such changes will be part of an ongoing process that will never quite converge on perfection.

All of this discussion, however, begs the ultimate question. Even if looking at old section 1034 allows us to understand more clearly what affirmative goal section 121 serves, what is the point of using the Code to serve the goal of allowing people to, in the most folksy of phrases, put all their eggs in one basket? This is especially difficult to defend when one learns that the rate of return on owner-occupied housing has actually lagged the rates of return on virtually every other asset (even savings accounts) over the post-World War II period. Was my alter ego not correct in arguing in his Affirmative comments that people should be encouraged to diversify their financial portfolios, not induced to place their financial bets on one spin of the wheel?

The answer to that question is that we must, when making policy, take the world as it is, not as we imagine it should be. The fact is that a broad range

of policies—not just tax-based subsidies, but financial and regulatory structures (such as the federally-backed mortgage agencies)—have combined with overwhelming social pressure to convince people that they should buy a house in which to live, rather than renting it. Telling people to put all of their money into a single asset—and a uniquely low-yielding asset at that—and then taking away the promised opportunity to take out their life savings tax free (if, indeed, they are lucky enough to need to cash out when the house has gone up in value), amounts to luring people out of all of the other tax-favored savings opportunities that are available, and then telling them, "Too bad, you trusted us!"

Moreover, it is not even a certainty that people are merely being irrational followers of social convention when they buy homes. Many people report that, even if they otherwise would be convinced that renting was better than buying, they nonetheless treat the payment of principal in their mortgage payments as a device to force themselves to save money each month, knowing that they would never have the self-discipline to save the same amount without the threat of a late payment fee. Taking people as they exist, we must recognize that homes are, for better or worse, the way that middle class people systematically save.

In short, while a better world would not involve subsidies of any kind for buying houses, there are good reasons to settle for what is currently achievable. Continuing to exclude from income any gains on home sales appropriately rewards people who are obeying social expectations, and who are doing the best they can to save for their futures. ■

Boxscore

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

TO	DATE	CODE SECTION	TITLE	COMMITTEE	CONTACT
Department of Labor	12/11/2012	ERISA 3(21)	Comments on Proposed Regulations Relating to the Definitions of "Fiduciary" and "Investment Advice" Under Section 3(21) of ERISA	Employee Benefits	Andrew L. Oringer, Joni L. Andrioff
Internal Revenue Service	11/27/2012	Circular 230	Comments on Proposed Reg-138367-06 Relating to Practice Before the Internal Revenue Service	Standards of Tax Practice	Michael Desmond
House Committee on Ways & Means, Senate Committee on Finance	10/3/2012	401, 409A, 414, 417, 430	Options for Tax Reform Regarding Employee Benefits and Executive Compensation	Employee Benefits	Mark Bodron
House Committee on Ways & Means, Senate Committee on Finance	10/1/2012	482, 1059A, 6662(e)	Options for Tax Reform in the Transfer Pricing Provisions of the Internal Revenue Code	Transfer Pricing	Sean Foley

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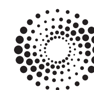
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