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FROM THE CHAIR

A Good Start

By George C. Howell, III, Hunton & Williams, LLP, Richmond, VA

I am pleased to report that the Tax Section’s 2015-2016 year is off to a productive start. I am excited by all that the Section, its members, and its staff are accomplishing. Beyond the usual high level of government submissions and pro bono activity, there are a number of items that I want to highlight for you.

ABA Tax Times

I am delighted to announce the inaugural issue of ABA Tax Times (formerly NewsQuarterly), the Section’s new, all-digital publication. Under the leadership of a new Supervising Editor, Linda M. Beale, together with Julie Divola, our Vice-Chair (Publications), and Anne Dunn and the rest of the publications staff, we are working hard to bring the Section’s publications into the 21st century. I hope you enjoy the enhanced format, which includes links to cited source material and other information, as well as audio and video clips for related content. To this end, I invite you to watch my first video message as Chair and to send us your feedback at taxweb@americanbar.org.

Fall Meeting

Our Joint Fall CLE Meeting with the Real Property, Trust and Estate Law Section (RPTE) in Chicago was successful and well attended by members of both Sections. Once again, best-in-class CLE programming was everywhere. On Friday and Saturday, I sat in on portions of a number of committee CLE panels, all of which were well done. In particular, I want to highlight the programs put on by our Diversity Committee and Young Lawyers Forum (YLF). If you have not attended one of their CLE panels in the past, I urge you to do so at the Midyear Meeting in Los Angeles. I am confident that you will find it to be a rewarding experience.
Another highlight of the Fall Meeting was the remarks of Nina Olson, the IRS National Taxpayer Advocate, at the plenary lunch on Saturday. Nina’s commentary is always well conceived and thought-provoking, but her description of the current state of our tax system and the existential challenges that it faces was the most accurate (and chilling) that I have heard. It seems clear that the low level of taxpayer service brought on by budget cuts and other factors is corroding our voluntary assessment tax system, which is the engine of our federal government and, in my view, one of the crown jewels of our republic. Nina believes that, once trust in the tax system is lost, it cannot be regained, and that continued corrosion will bring us to that point of no return sooner, rather than later. Unfortunately, I think she is right. Her remarks should be a clarion call to action.

In the course of her remarks, Nina announced that she will hold public hearings around the country during 2016 to gather information and feedback about the IRS's ongoing service problems and the impact that they are having on taxpayers. She also will ask for input on how the IRS should operate in the future. We in the Tax Section should do everything that we can, both individually and collectively, to support Nina’s efforts to focus attention on, and begin a search for solutions to, the difficult problems faced by the IRS and our tax system.

I want to thank the Section’s staff, led by Janet In, for all that they did to make the Fall Meeting a success. Although the staff’s hard work is largely behind the scenes, it is what makes our meetings run so smoothly. As a Section, we are fortunate to have such a talented, tireless, and effective staff.

Cooperation with RPTE

The Tax Section and RPTE have much in common. This commonality is illustrated by the fact that there are almost 4,000 Tax Section members who are also members of RPTE. Since 2003, we have successfully conducted joint fall meetings with RPTE. As the two Sections have considered ways to expand their cooperative relationship, cross-marketing of membership has seemed like a logical next step. I am pleased to announce that RPTE has agreed to offer a free, one-year membership to all Tax Section members who are not currently RPTE members. The offer will run through December 31 and will apply to the 2015-2016 fiscal year, which ends August 31, 2016. The Tax Section will make the same offer to RPTE members who are not currently Tax Section members. If you have not already received information about this offer, you will shortly. I urge you to take advantage of this wonderful member benefit.
TAPS Endowment Task Force

As you undoubtedly have heard, the Tax Assistance Public Service (TAPS) endowment has been established to assure long-term funding for the Brunswick Fellowships and the Section’s other pro bono and public service efforts. I have created a task force to formulate and execute our fund-raising strategy for the TAPS endowment. The task force is expected to remain in existence for approximately five years with the members serving two-year terms. The task force will be chaired each year by the Section Chair and will have three other ex officio members—the Immediate Past Chair, the Chair-Elect, and the Section Director. Fourteen other appointed members bring the total membership to 18.

The Section has raised more than $275,000 in gifts and pledges to date, but we have a long way to go to achieve our goal of $2.5 million. This is an ambitious objective, but I know that we can achieve it with your support. Guided by the task force, a more visible fund-raising campaign will begin soon. Please respond generously when you are contacted. Tax-deductible contributions to the TAPS endowment are made through the ABA Fund for Justice and Education.

Pro Bono Opportunity

Over the years, the Tax Section has established a variety of participatory pro bono and public service programs for its members. As we draw closer to the end of the calendar year, I want to highlight the wonderful opportunity provided by the Section's Adopt-A-Base Military VITA Training Program. In this program, a law firm or group of volunteers “adopts” a nearby military base and agrees to provide training to both military personnel and civilians who will operate a VITA center on the base. The IRS formerly provided this training, but it can no longer do so because of budget cuts. I have participated in this program and can vouch for the enormous psychic benefits derived from helping our men and women in uniform. I strongly encourage you to respond affirmatively if you are contacted by Wells Hall, the Vice-Chair (Pro Bono and Outreach), or Derek Wagner, the Section’s Pro Bono Counsel, about participating in this program. Better yet, take the initiative to contact Wells or Derek to let them know of your interest in Adopt-A-Base. To learn more about this and other tax–related pro bono opportunities, please refer to the Pro Bono Opportunities page on the Section’s website or contact Derek B. Wagner.

Diversity, Inclusion, and Nolan Fellowships

As I previously have reported to you, the Tax Section’s council has adopted an updated Diversity and Inclusion Plan, which is available on the Section’s website. With the
help of the Section officers, committee leadership, and the staff, implementation of the action steps laid out in the plan is well underway. One of the goals of the new plan is to increase our membership rolls by bringing in younger and more diverse members. The Diversity Committee and the YLF are playing key roles in helping the Section achieve that goal. I am pleased by the momentum that both are building. For example, the Diversity Committee/YLF reception at the Fall Meeting was one of the best attended that I have seen. We need to do everything possible to support these two vital branches of the Section, which will provide the foundation for our future health as a membership organization.

In that same vein, I want to remind everyone that the deadline for Nolan Fellowship nominations—December 4, 2015—will be here before we know it. Nolan Fellowships are a wonderful way to support and recognize the involvement of young and diverse lawyers in the Section. Please consider appropriate candidates that you may know and take the time to submit a nomination form. The criteria for selecting Nolan Fellows, the nomination form, and more information about the Fellowships can be found on the Section’s website.

Withdrawal of House of Delegates Resolution

I am disappointed to report that the Section decided to withdraw ABA House of Delegates Resolution 101. This resolution urged Congress to undo the damage to the scope of Circular 230 done by the Loving and Ridgely cases. The resolution called for two legislative amendments—one to expand the scope of Circular 230 to allow regulation of non-lawyers in return preparation and a second one clarifying the authority of the Treasury Department to regulate all persons, including lawyers, who advise taxpayers with respect to the reporting of items on federal tax returns. Unfortunately, this latter provision was seen by many in the House of Delegates as running afoul of the ABA’s longstanding position against federal regulation of lawyers. In light of this strong opposition, the Section reluctantly (but in my view wisely) decided to withdraw the resolution. I invite you to read the Remarks of Section Delegate Richard M. Lipton before the ABA House of Delegates on August 3, 2015 featured in this issue of ABA Tax Times, which also links to the full resolution and report available on the website.

Looking Forward

Two more CLE-packed meetings await us over the remainder of the 2015-2016 year—the Midyear Meeting and the May Meeting. I urge you to attend the Midyear Meeting, which will be held January 28-30 at the JW Marriott LA Live near downtown Los Angeles. I am confident that it will be a productive meeting for all who attend. I also hope that you will participate in some of the upcoming CLE programming that will occur outside of the
Midyear and May Meetings. The quality and price of the Section's meetings and CLE is the best around.
INTERVIEW

Karen L. Hawkins

By Thomas D. Greenaway, KPMG LLP, Boston, MA, and Jasper L. Cummings, Jr., Alston & Bird LLP, Raleigh, NC, and Washington, DC

Karen L. Hawkins was, until July 2015, Director of the Office of Professional Responsibility (OPR) of the IRS. At the time she was appointed by the IRS Commissioner to serve as the Director of OPR, Karen was Chair-Elect of the Tax Section.

Q: You now live in Oregon, a long way from Washington, DC. Tell us about your new home.

A: I’m on the coast—a 7-iron from the beach (for the non-golfers, that’s about 135 yards). I bought in a brand-new small development so was able to do some customizing of the three-story stand-alone structure, but it’s all about the view. My third floor has breathtaking views of ocean, sky, and beach. Right now, two of those are the bluest you’ll ever see, but the winter storms will be spectacular.

Q: Do you think coming from a small, West Coast law firm affected the way you approached your position as OPR director?

A: No. Being a tax lawyer for the previous 30 years affected the way I approached the position.

Q: Your goals as OPR director were to enhance the credibility, visibility and stature of the Office of Professional Responsibility and Circular 230 at all levels of professional tax practice. You spoke to thousands of practitioners during your tenure. What was so important to you about making all those speeches, panel presentations, and trips?
One of the things that frustrated me about listening to previous directors was the vague way in which they responded to the all-important question from practitioners: “What will get me in trouble?” I don’t believe that everyone instinctively knows what “the right thing to do” is all of the time; or how to distinguish a “foot-fault” from a serious transgression. Most of the case law available in 2009 dealt with practitioners’ own tax non-compliance, so vague principles were not helpful in interpreting anything in Circular 230 except section 10.51(a)(6) [willful failure to file returns or pay tax]. I believed (then and now) that the real harm being done to taxpayers and the tax system involved violations of the various due diligence provisions in Circular 230 which occur in epidemic proportions. I believed that the Director is responsible for articulating the ways in which the various “rules” will be interpreted and that the OPR approach to discipline needed to be absolutely transparent in order to withstand scrutiny. As part of an administrative agency, OPR has a responsibility not to act in arbitrary or capricious ways, abuse its discretion or act contrary to law. It also owes practitioners timely and consistent investigations and determinations. Practitioners need to trust that the system is treating them fairly even when they are alleged to have behaved badly. I believed that the more visible, transparent and, if you will, “out-front” I was with practitioners, the more they would pay attention to the rules and think about them in everyday application before acting, rather than after the fact. OPR is not a function that should ambush practitioners. It was important to communicate up front how we were going to interpret and apply the rules, not after the behavior had occurred. OPR reached 60,000 to 75,000 practitioners annually during my tenure as Director. Circular 230 became a part of the everyday lexicon of thousands of tax professionals. I think my mission was accomplished.

What changes or developments are you most proud of from your time at OPR?

Getting away from an inventory that made OPR a sub-function of the IRS Collection Division was an important accomplishment. OPR had no credibility as long as it was acting almost exclusively as a tax compliance function.
Another thing I am very proud about is the level of Circular 230 consciousness that was raised in practitioners at every level. I can recall when, even at the Tax Section, discussions about Circular 230 occurred only at the Standards of Tax Practice Committee meetings. The rest of the committees presented programs on “pure” substantive material. Over my 6 years as Director, that attitude changed dramatically; as a result, discussion of the Circular 230 implications of foreign tax planning, employee benefits advice, corporate tax advising and even obligations to low-income taxpayers was occurring on a pretty regular basis at each meeting. Perhaps even more significantly, I was being asked to sit on panels for committees like Employee Benefits, Corporate, Partnerships, and Estate Planning that wanted to inject a level of ethical discussion into their substantive materials. It has been really gratifying.

When I started speaking in mid-2009, the only practitioner group (as a whole) who knew Circular 230 existed and its connection to OPR was the Enrolled Agents. For the first few years before each presentation, I would ask the questions: “Who has heard of Circular 230?” and “Who knows what OPR does?”—hardly any hands would go up. By 2014, I stopped asking those questions and started asking “How many of you have heard me speak before?” because most of the room had.

I also like to think that OPR’s reputation was enhanced considerably during my tenure, but that’s harder for me to measure except subjectively.

Q What were your biggest frustrations from your time at OPR?

A I don’t know if I really had any big frustrations except the usual ones you hear from people like me who weren’t raised in the government work environment: too many meetings; too much process and not enough implementation; long time-frames to accomplish anything.

I suppose I could say Loving and Ridgley were “frustrations,” but that’s not exactly correct for me. I’m a litigator; stuff happens; you regroup and move forward. I was certainly disappointed by the results in both those cases and by the lack of anticipatory strategizing that occurred during the process. In my opinion, the Agency was more “flat-footed” than it needed to be.

Q What was the most common practitioner problem you saw in your time as OPR director, and what advice do you have for a practitioner who never wants to hear from OPR?
I have emphasized repeatedly in my speeches that it’s all about specific facts and circumstances, so it’s hard for me to list the top 10 transgressions. Every one has its own wrinkles. I’d say generally that a failure to do adequate due diligence for the issue/work involved, whether it be advising on a filing position or how to make a deal with collection or preparing a tax return, resulted in the most referrals from IRS enforcement personnel.

Many practitioners have an odd sense that if they don’t ask tough questions, they won’t hear bad answers and therefore can avoid having to give the client bad news. Tax return preparers especially practice the “don’t-ask-don’t tell” philosophy of tax advising. If the taxpayer understood the nuances of all the tax laws that apply to a particular situation, s/he would not need to pay an advisor. Part of being a competent tax professional is asking the tough questions and, when necessary, addressing the “bad news” appropriately.

I also think many practitioners take on matters that they are not competent to handle and then think their due diligence is adequate if they’ve read an article on the topic. I was stunned at how many tax professionals did not read the relevant law at issue and failed to do adequate probing of the client’s facts before advising on, or taking, a position. Assuming the law “should” be “X” or shooting from the hip is never adequate due diligence. Nor is blindly relying on client information when there are discrepancies, unfounded assumptions or relevant factual omissions. Too many return preparers assume they are “home-free” if they use all the information provided by the client on a pre-prep systemizer/questionnaire.

Also, I think there is an attitude among some of those who do the most sophisticated tax advising that it’s all about how cleverly they can parse statutory language to justify whatever the client has asked for. I’m not sure when the profession stopped asking itself whether something was “the right thing to do,” but that concept is clearly missing from many repertoires these days. I come from a gentler era in tax advising when only the unprofessional shysters engaged in ludicrous tax structuring. Now, especially in this era of anemic funding for the IRS, the mantra at every level seems to be: “catch me if you can.”
Getting away with something is not the same as giving good, appropriate tax advice; nor is it an indicia of someone’s competence.

Q  Any common patterns in the cases you saw? Are there any OPR “traps for the unwary” out there?

A  There still are a lot of practitioners out there who think filing their own returns and paying the tax is something their clients must do, but is not necessary for them.

The biggest “pattern” is the lack of due diligence, however you want to say it: shooting from the hip when advising or preparing a tax return; failing to ask detailed questions; failing to recognize a lack of competence to perform the service being charged for.

After all the speaking I have done, if there are any “traps for the unwary,” someone wasn’t paying attention!

Q  The ABA Tax Section supports Treasury regulation of non-attorneys, and your vision as OPR director was to bring reasonable but firm oversight to the unregulated return-preparer industry. Did you still share that vision by the time you left?

A  I absolutely believe that the agency should have the authority to regulate all interactions by all persons regarding matters administered by the IRS. And I have been grateful for the Tax Section’s support on this issue, although it was my understanding that the ABA parent organization was not supportive of such a broad perspective.

It has been referenced repeatedly that tax return filing is the single most likely interaction a taxpayer will have with his/her government. And for many, it is the most serious financial transaction in which s/he will engage. To allow untested, uneducated individuals to charge for services in connection with tax advice or tax preparation is an unconscionable oversight by Congress.

Notwithstanding what the Loving courts said about the Title 26 penalty regime, the penalty approach will never solve the problem of incompetence or lack of integrity. Penalties are there to punish after the fact and require enormous resources to administer—resources the IRS apparently will not have for the foreseeable future. The goal that Commissioner Shulman and I shared was to address the incompetence and instill the integrity (or at least an understanding of a practitioner’s ethical obligations to a client) before the advice is given, before the return is prepared, before representations are made to the IRS. With the invalidation of the regulations governing return-preparer oversight, that effort has
experienced a major set-back. With the *Ridgley* decision, respect for what OPR and Circular 230 are intended to accomplish has been further eroded.

**Q** Loving says Circular 230 doesn’t cover return preparers, Ridgely says Circular 230 doesn’t cover regular refund claims, and the Sexton and Davis cases seek to stop OPR and IRS from regulating who can file tax returns on behalf of clients. Is there any hope of saving Circular 230 and OPR through litigation, or do we need to wait for Congress to act?

**A** You’ve mischaracterized the cases. Loving says “mere” tax return preparation does not constitute the act of representation. Even Judge Boasburg acknowledged that in some instances return preparers might be subject to Circular 230 and explicitly stated that CPAs and attorneys were covered by the regulations. *Ridgely* emphasizes that “ordinary” refund claims are so similar to “mere” tax return preparation that *Loving* must be followed as precedent. Davis was settled without consequence so we really cannot draw any conclusions from that. Sexton is not about filing tax returns: it’s about giving sophisticated, written, tax-planning advice while suspended from practice. That being said, I do think it will be best if Congress acts to resolve the authority once and for all, but the proposals I have seen so far are inadequate. More recently, the AICPA is playing the “unfair competition” card—a red herring, in my opinion, but one which seems to be making headway in light of no organized or vocal opposition to the contrary.

The thing about *Loving* and *Ridgley* is that they were both what I call “pre-emptive” strikes; that is, there was no practitioner involved who was actually being investigated by OPR. It was easier for the courts to focus on the “pure” language and parse it in a vacuum to their liking. I’ve testified at administrative disciplinary hearings where some of the same arguments were raised in defense but the bad acts of the practitioner propounding them made those arguments less compelling to the court. It’s less easy to be a purist when there’s a real victim or victims involved.

**Q** What’s different in the practice of tax since you started? What long-term trends or cycles have you observed?

**A** Tax schemes are like locusts—there seems to be a ten-year cycle. By that measure, I think we are about due for another round of abuses. The problem is that just as bugs become immunized to the poisons meant to eradicate them, so do scammers, who find more sophisticated ways to game the system. The other sad aspect, in my opinion, is that greed is blinding even the highest levels of the tax profession. It’s no longer about getting it “right” for the client and the system. It’s about playing the audit lottery and the cost-benefit analysis of getting caught.
In my early years of practice, you could sit with fellow “tax geeks” and speculate about hair-brained schemes that could technically be read into a specific statute or regime of statutes. Then everyone would laugh and acknowledge that implementing a transaction using such an analysis would not be the right thing to do (for the client or the system). The difference now is that there does not appear to be a “conscience” in the room when some of these schemes are being developed. It’s all about the cost of getting caught being outweighed by the tax advantages produced. Hmmmm, this is the first time I have felt as old as I am!

Q You credit mentors you met through the ABA Tax Section (like Jules Ritholz and Marvin Garbis) for helping your professional development. How would you encourage younger and diverse members of the Section to find and cultivate mentors?

A I think this is a two-way street. More seasoned tax professionals need to be aware of those around them who might benefit from mentoring. I was fairly assertive about attracting the attentions of those I thought would serve as good role models—the mentoring just fell into place after the relationships were established.

If young tax lawyers want to be respected and included, they must perform the tasks to which they have committed; volunteer for the drudgery as well as the fun stuff; exercise absolute discretion; maintain confidences and be visible as much as feasible. I also think that the younger generation’s digital “culture” cuts against recognition by us older folks. Case in point: I had occasion to attend an event for tax lawyers a year or so ago where a number of LL.M. students were in attendance. One of them had recently drafted an article on Loving. One of the hosts for the evening assumed this student would want to meet me, so we were placed at the same table. My efforts at conversation (Loving and otherwise) were substantially thwarted by the student's constant reading and sending of text messages and departures from the table to make or receive calls. There was no question this student was bright, but I wrote him off immediately as someone I did not care to spend any further effort on. Whether you are with a client or a potential mentor, staying “in the moment” is a key skill that seems to be lost on many (not necessarily younger) tax lawyers.

Q What advice do you have for individuals, the Tax Section, and our profession on how to foster diversity in the tax bar?

A We are all more comfortable with those we perceive as “like us,” whether that is as a result of education, politics, religion, color, sexual orientation, or being tax law nerds. I am honored to have been a part of Council when the Young Lawyers Forum and the Tax
Law Challenge were initiated. I think those two efforts have been enormously successful in attracting the future leaders of the Section.

As to other kinds of diversity, I think the efforts have to be a bit more overt because we cannot assume that certain individuals know they will be welcome or can easily see the benefits of being involved. I have been off Council for 6 years so I apologize if I am unaware of any efforts already on-going in this context, but I think the Section should be far more overt in seeking the diverse membership it purports to want. That for me means funding visits to non-traditional campuses and events to interact with the students; being willing to solicit, listen to, and then adopt suggestions from more diverse points of view; making efforts not just to be welcoming but also to recruit diversity of involvement in all Section initiatives.

Q  What’s next for you, Karen?

A  Well, I’m still waiting for my furniture to arrive from the East Coast (which I hope will be soon), and I am still busy being mesmerized by the incredible view that greets me every morning. I also accepted speaking invitations at nine different tax conferences between August and the middle of December, so I’m not going to sleep anytime soon.

I have an energizer bunny for a mother who just turned 93 in August. I will be spending some time deciding how best to situate her (she’s living in northern California) vis-à-vis me for the future now that I know what my new mailing address will be.

I have not been particularly organized about long-term planning at the moment, but I see my highest and best uses going forward as expert witnessing, Circular 230 risk analysis and consulting, educational (speaking and/or teaching), and writing. I have agreed to write a column three times a year on ethics for the CCH Journal of Tax Practice and Procedure. I’m also considering speaking engagements (for pay) with a couple of CLE providers who have approached me.

It goes without saying that I intend to continue with Tax Section activities. The current chair has already asked me to serve on a couple of committees, which I am more than happy to do. I hope the Standards of Tax Practice Committee will accept my involvement when appropriate. And, as you saw in Chicago, I am happy to contribute to the Section’s CLE activities, again, as appropriate.
POINT TO REMEMBER

‘Just Add SaLT!’ When and How to Consider State Tax Ethical Issues in Advising Clients

By Professor Michael B. Lang, Chapman University Dale E. Fowler School of Law, Orange, CA, and Rachel L. Partain, Caplin & Drysdale, Chartered, New York, NY

Introduction: This material was initially presented as part of a panel discussion of the State and Local Taxes Committee co-sponsored by the Standards of Tax Practice Committee at the ABA Section of Taxation’s May Meeting held in Washington, DC on May 8, 2015. The authors were panelists, as was Marilyn Wethekam, Horwood Marcus & Berk Chartered, Chicago, IL; the moderator was Phillip Pillar, Grant Thornton LLP, Philadelphia, PA. The audio recording of the panel is available at State & Local Taxes Part 2.

Lawyers who practice in the state and local tax (SaLT) area have unique ethical concerns given that their clients’ legal matters often involve multiple jurisdictions. This article discusses several ethical rules particularly relevant to SaLT lawyers. It is vital that lawyers consider these issues when commencing an engagement and throughout the representation: a violation of an ethical obligation could jeopardize a lawyer’s ability to collect fees for services and potentially result in a malpractice or disciplinary action.

SaLT Representations Involving Multiple Jurisdictions: Ethical Implications of the Attorney-Client Relationship

A SaLT lawyer is often engaged to provide advice to clients about the tax laws of several states, including states other than the lawyer’s state of licensure. This practice raises at least three important ethical concerns: (1) unauthorized practice of law, (2) competence, and (3) communication with the client.

In general, a lawyer may not practice law in a state in which she is not admitted to practice.\(^1\) Model Rule 5.5(a) also makes it a violation of a state’s rules of licensure to practice law in another state in violation of the other state’s rules (or to assist someone else

\(^1\) See Model Rule 5.5(a).
in doing so). As a result, a lawyer who practices law in a state other than her state of licensure without being admitted may be subject to discipline by either jurisdiction.

What is meant by practice of law “in a state” may vary from jurisdiction to jurisdiction. However, since state Bars perceive themselves as protecting their own citizens, practice of law in a state is most likely to arise when a lawyer (1) represents citizens or businesses of the state in legal matters involving the application of the laws of the state, or (2) spends substantial time in the state dealing with in-state persons, courts, agencies or businesses on behalf of out-of-state clients. If a lawyer that is not licensed to practice in a state represents a client who resides or has its principal place of business outside of that state, and merely advises the client on the state’s tax laws, the lawyer's activity is unlikely to be regarded as the practice of law in that state. Thus, a SaLT lawyer licensed in Ohio should be able to provide advice to Ohio clients on the laws of other states without the risk of being charged with unauthorized practice of law.

In addition, it should be noted that in some states it may not be necessary to be a lawyer to represent someone before a state revenue agency. Accordingly, an out-of-state SaLT lawyer appearing before a state revenue agency in such a state may not be engaged in unauthorized practice of law as such, although some activities related to the representation might be so characterized. Similarly, in states in which representing a client in a mediation or arbitration is not regarded as the practice of law, a lawyer who does so outside his state of licensure may not be regarded as engaging in the unauthorized practice of law. Note that, in either circumstance, an out-of-state lawyer is prohibited from setting up an office or maintaining a continuous presence in those states.

The general rule barring practice in a state in which a lawyer is not licensed is subject to a number of exceptions that permit an out-of-state lawyer to provide legal services in a state on a temporary basis. Under the Model Rules, these exceptions include (1) providing services in association with a locally licensed lawyer who actively participates in the matter, (2) providing services in or reasonably related to a pending or potential proceeding before a tribunal if the lawyer or one assisting the lawyer is authorized by law or order to appear in such proceeding or reasonably expects to be so authorized, or (3) providing services in or reasonably related to a pending or potential arbitration, mediation, or other alternative dispute resolution proceeding if the services are reasonably related to the lawyer’s practice.

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2 See id.
3 Model Rule 8.5(a). For the choice of law rule, see Model Rule 8.5(b).
4 Model Rule 5.5, Comment 2.
6 See Model Rule 5.7.
7 See Model Rule 5.5(b)(1).
8 Not all states follow the Model Rules. California, for example, has more restrictive rules.
in a state of licensure and are not services for which pro hac vice admission is required.  
These exceptions reflect the long-time practice in many jurisdictions.

Of greater controversy is Model Rule 5.5(c)(4), which excepts from the general rule the provision of services “arising out of or reasonably related to the lawyer’s practice” in the lawyer’s state of licensure.  
Comment 14 elaborates on this vague language, mentioning factors that may be relevant in applying the “reasonably related” standard, including whether (1) the lawyer previously represented the client, (2) the client is resident in or has substantial contacts with the jurisdiction of the lawyer’s admission, (3) the matter has a significant connection to the jurisdiction of the lawyer’s admission, (4) a significant aspect of the matter may involve the law of the jurisdiction of admission, and (5) multiple jurisdictions are involved.  
The Comment then adds that “the services may draw on the lawyer’s recognized expertise developed through the regular practice of law on behalf of clients in matters involving a particular body of federal, nationally-uniform, foreign, or international law.”  The “nationally-uniform” language probably provides some limitation on what subjects may fall within this section; however, given the general approach of Comment 14, that limitation is unlikely to be highly restrictive.

Thus, under Model Rule 5.5(c)(4), a SaLT lawyer who is a leading expert on the state taxation of the gambling industry may be permitted to provide services regarding the state tax laws applicable to the gambling industry, even if none of the relevant jurisdictions is one in which the lawyer is admitted to practice.  If the same out-of-state SaLT lawyer does this too often for clients in the same state, at some point she will cross the “temporary” line and be in violation of the state's rules, but it is not clear how this line is drawn.

It should be clear that a SaLT lawyer can do a great deal for out-of-state clients without implicating a violation of unauthorized practice of law provisions.  The other ethical concerns relating to a multiple-jurisdiction representation, competence and communication with the client, become most important when the lawyer’s actions fall into an exception to the restrictions on the unauthorized practice of law.

Competent representation requires that the lawyer possess, inter alia, the legal knowledge and skill “reasonably necessary for the representation.”  
For a SaLT lawyer, this means knowledge not only about the relevant state tax laws but also about other relevant state laws and even federal laws.  Of particular importance in this vein may be state laws governing real property and other areas where state laws have considerable variation.
A lawyer has a duty to communicate with a client, including a duty to “explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation.”\textsuperscript{13} In the context of advising a client about the tax laws of another jurisdiction, the lawyer should explain what the lawyer can and cannot do, how the lawyer’s expertise may be limited, and note the fact that the lawyer is not admitted in the other jurisdiction as well as any disadvantages that this may entail for the client.

**SaLT Representations Involving Multiple Jurisdictions: Ethical Implications of Co-Counsel Arrangements**

Given the considerations discussed above, SaLT lawyers often work with co-counsel, particularly local counsel. In such situations, a common concern is fee-sharing agreements. \textsuperscript{14} Model Rule 1.5(e) governs fee sharing: (1) the aggregate fees paid by the client to the lawyers must be reasonable, (2) the division of fees between the lawyers must be proportional to the services performed by each (or each lawyer must assume joint responsibility for the representation), and (3) the client must consent in writing to the division of fees between co-counsel. A fee-sharing agreement that does not comply with these rules may be treated as unenforceable, potentially impacting both lawyers’ abilities to collect their fees. An agreement that fails to comply may also lead to disciplinary proceedings.

Although not specified in the Model Rule or the comments, a best practice is to obtain written consent to the fee-sharing agreement as soon as it is contemplated that co-counsel will become involved in a matter.

**SaLT Representations Involving a Single Jurisdiction**

While SaLT lawyers may advise clients on the laws of several states, a SaLT lawyer may also advise a particular client solely on the laws of a single state. An important ethical issue in this situation is defining the scope of representation. This issue is of particular concern in SaLT practice, given that SaLT clients frequently have related legal matters in multiple jurisdictions. In some cases, the scope of representation issue will be obvious. For example, a prospective client might have open tax examinations in several different states and might engage a California SaLT lawyer solely in connection with the client’s California Franchise Tax Board examination. In other cases, the fact that the lawyer is being engaged by a client on essentially a limited-scope basis may not be apparent.

\textsuperscript{13} Model Rule 1.4(b).
\textsuperscript{14} See Model Rule 1.5(e).
Express Limitations on the Scope of Representation

A client with multiple matters in different jurisdictions may choose to retain an attorney for a specific matter.15 Similarly, an attorney may “limit the scope of the representation if the limitation is reasonable under the circumstances and the client gives informed consent.”16

In the best-case scenario, a lawyer will have recognized any known or potential related matters with respect to a particular client in advance of retention and clearly delineated the scope of representation in the engagement letter.

There appears, however, to be a tension between the duty to communicate and the scope of representation. Even when a lawyer diligently documents the scope of representation at the commencement of an engagement, it is unclear whether the duty to communicate requires the lawyer to advise the client of matters that lie outside that scope of representation. As discussed above, the duty of communication requires a lawyer to explain matters “reasonably necessary” for the client to make an informed decision regarding the representation.17

As an example, if an engagement letter clearly states that the scope of representation involves handling only a state tax examination, does the lawyer nonetheless have an obligation to inform the client that any adjustments agreed to in the state examination may affect the client’s federal tax liability as a result of information sharing between the IRS and several states?18 A client who agrees to haircut certain Schedule C deductions for state tax purposes could potentially incur an aggregate federal and state tax liability of 5 times or more the amount of the agreed-upon settlement with the state. Further, should the lawyer affirmatively advise the client that interest on any federal underpayment runs from the due date of the return and that the client should consider making a deposit of tax to stop the running of interest?19

Another example is the reverse situation. Certain states require taxpayers to provide notice of any adjustments to their federal tax liability within a certain number of days of the change.20 A failure to notify the state results in the suspension of the statute of limitations on assessment. Does a SaLT attorney representing a client solely in a federal tax

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15 See Model Rule 1.2(a).
16 Model Rule 1.2(c).
17 Model Rule 1.4(b).
18 See PMTA 2008-01789 (April 18, 2008).
19 If the lawyer does inform the client of the federal tax implications of a state settlement, has the SaLT lawyer now become subject to Treasury Circular 230? See Treasury Circular 230 § 10.37 (written advice standard).
20 See, e.g., N.Y. Tax. Law § 659 (within 90 days).
examination have an obligation to communicate the state reporting requirements to the client?

If a lawyer interprets the duty to communicate broadly and informs a client of matters clearly outside of the scope of representation that may be affected by the decision the client makes with respect to the representation, there is a risk that the client or a disciplinary authority could view the scope of representation as having been expanded. In such a case, the lawyer likely would be subject to increased obligations to the client.

One method to resolve these concerns may be for the lawyer to mention, generally, that state changes may have repercussions at the federal level or with other states while clarifying that providing advice regarding any such consequences is beyond the scope of engagement. Alternatively, the lawyer might include in her first discussions with the client an express statement that the lawyer will not communicate about matters outside the scope of representation and that there may be material risks to the client of such a limitation on the duty to communicate.21

Imprecise Scope of Representation

The preceding discussion was based on a clear delineation between covered and not covered matters in the scope of representation. In contrast, an engagement letter with an imprecise scope of representation implicates an exponential number of ethical issues.

The scope of representation may be imprecise if the lawyer does not draft the engagement letter well or fails to consider the client’s other matters that are related to the covered matter. In some cases, a lawyer intentionally drafts the scope of representation broadly in the hope of representing the client on additional matters in the future. Under general contract principles, an imprecise scope of representation in an engagement letter may be construed against the lawyer as drafter.

An imprecise scope of representation implicates several important ethical rights and obligations, including the fees the lawyer is entitled to receive. Model Rule 1.5(b) requires that the basis or rate for the lawyer’s fees be clearly communicated to the client, preferably “in writing, before or within a reasonable time after commencing the representation.”22 When the scope of representation is imprecise, the lawyer’s right to fees for the representation may be unclear. A lawyer may be unable to collect fees for any additional services that are ultimately construed to be within the scope of representation.

This is especially true when a flat fee or other alternative fee arrangement is used. For example, suppose a lawyer who is retained to handle an IRS examination drafts an

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21 See Model Rule 1.2(c) and Model Rule 1.0(e).
22 Model Rule 1.5(b).
engagement letter that states that the scope of representation covers “tax matters” for a flat fee in the amount of $150,000. A few months after the completion of the examination, the client receives a notice from New York State indicating that additional state tax is due. In this situation, under Model Rule 1.5(b), there is a real risk that the client might demand (and a state Bar would agree) that the New York State matter be treated as within the scope of representation. As a result, the may be unable to charge additional fees for handling the matter.

If the scope of representation is construed to be broader than the lawyer originally envisioned, the lawyer may also have breached duties owed to the client with respect to the additional matters, such as avoiding conflicts of interest.23

Conclusion

This article has addressed how SaLT lawyers might (or rather, should) consider some of the many ethical issues that typically arise in SaLT representations. As for when these issues should be considered: “early and often” would certainly be a good practice. ■

23 See Model Rule 1.7.
POINT TO REMEMBER

Wynne Is a Win for Most State Taxpayers

By Robb A. Longman, Longman & Van Grack, LLC, Bethesda, MD

On May 18, 2015, the United States Supreme Court issued a 5–4 decision in favor of the taxpayer in a dormant Commerce Clause tax case involving respondents Bryan and Karen Wynne and the Maryland income tax laws. Although Maryland allowed credit for out-of-state taxes paid by residents and non-residents, the state did not apportion or apply that credit to a taxpayer’s county taxes. The Court concluded that the failure to take out-of-state taxes into account in determining the Maryland residents’ county taxes violated the dormant Commerce Clause.

This decision will most likely affect not just Maryland, but also New York, Indiana, and Pennsylvania, all of which have similar provisions in their state income tax laws. The benefit is to all taxpayers located in those states that have an interest in a pass-through entity such as a partnership, limited liability company or S corporation, where the entity produces income in more than one state.

Case Background

The case was brought by the Wynnes, a couple living in Maryland who owned an interest in Maxim Healthcare Services, Inc., an S-Corporation that produced income in 39 different states. The Wynnes paid all of their taxes in Maryland, where they resided, as well as in other states where the income was produced. When they filed their Maryland tax return, they claimed a credit against Maryland’s state and county taxes for taxes paid to the other states.

Maryland’s State Comptroller allowed the credit against state taxes but disagreed with the claim for credit against county taxes and therefore assessed a deficiency against the Wynnes. When the taxpayers received the assessment, they followed the procedural requirement in Maryland. A hearing with appeals affirmed in the Comptroller’s favor. The Wynnes then appealed to the Maryland Tax Court, which also found in the Comptroller’s favor. They next appealed to the Maryland Circuit Court for their jurisdiction and were

rewarded with a ruling in their favor holding that the Maryland law violated the Commerce Clause. The Comptroller appealed to the Maryland Court of Appeals, Maryland’s highest court. That court affirmed the Circuit Court’s holding based on *Complete Auto Transit, Inc. v. Brady* and its determination that the Maryland law failed the fair apportionment and nondiscrimination parts of the *Complete Auto Transit* test. The Comptroller appealed that decision to the Supreme Court, which ruled in favor of the taxpayers.

**The Court’s Opinion**

Justice Alito wrote the opinion of the Court, in which Justices Kennedy, Breyer, Sotomayor, and Chief Justice Roberts concurred. The Court relied on precedent finding generally that the dormant Commerce Clause prevents states from imposing a tax that discriminates against interstate commerce by providing a benefit to local business or subjecting interstate commerce income to multiple taxation.

In particular, the Court looked to three cases involving a state’s attempt to tax the portion of a corporation’s gross receipts derived in other states. The dissent argued that these cases should not be seen to protect the Wynnes, because they deal with gross receipts rather than net income. The Court countered that more recent cases, such as *Complete Auto Transit*, had made clear that the gross receipts/net income distinction was no longer relevant. The State argued that these cases involving corporations should not govern here, because individuals receive services from their home state and have the right to vote for legislators of their choice who make the local laws and lobby them to change tax laws. The Court dismissed this argument, noting that “it is hard to see why the dormant Commerce Clause should treat individuals less favorably than corporations” and that the precedents cited applied the same law to corporations and individuals. Further, corporations also receive services from states and have the ability to lobby government for favorable laws. The ability of residents to vote and thus influence changes in the laws that affect them directly is not a sufficient reason to overlook a discrimination problem, the Court said: “[I]f a State’s tax unconstitutionally discriminates against interstate commerce, it is invalid regardless of whether the plaintiff is a resident voter or nonresident of the State.”

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2 430 U. S. 274 (1977). This case asks whether a “tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State.” *Id.* at 279.

3 The Court cited, among other cases, *Northwestern States Portland Cement Co. v. Minnesota*, 358 U. S. 450, 458 (1959), for its statement that a tax that subjects interstate commerce to the “burden of multiple taxation” is discriminatory under the Commerce clause. *Id.* at 6.


5 *Slip Op.* at 11.
The Court then examined the “county” tax applied to residents who earn income in other states under its “internal consistency” test, which “looks to the structure of the tax at issue to see whether its identical application by every State in the Union would place interstate commerce at a disadvantage compared to intrastate commerce.” The Court concluded that Maryland’s law would burden interstate commerce under this test by favoring income earned within the state. The Court went on to suggest that the problem could be corrected either by providing a credit to residents who pay taxes in other states or by removing that state tax from non-residents.

**The Dissents**

Justice Scalia dissented, joined by Justice Thomas in part. Justice Scalia reiterated his long-held constitutional objection to the judicial doctrine of a “dormant” Commerce Clause that requires the Court to determine the relative interests of commerce and states even in areas in which Congress has not legislated. The Scalia dissent noted the inconsistencies that abound in the Court’s dormant Commerce Clause precedent, providing a series of examples illustrating the contradictions in the cases and arguing that the Wynnes should not prevail under appropriately applied precedent. Justice Thomas joined in both of these assessments. Justice Scalia’s dissent included a third part setting out the way he would vote on dormant Commerce Clause cases in general, in which Justice Thomas did not join.

Justice Thomas dissented separately (joined in part by Justice Scalia), noting his view that the dormant Commerce Clause jurisprudence made no sense and was “unworkable in application”. Justice Thomas found the new requirement that all states must provide a full credit for taxes paid to other states to be a change from the historical understanding of state taxation under the constitution and not in accord with the Court’s own precedents.

Justice Ginsburg wrote the principal dissent, joined by Justices Scalia and Kagan. She argued that the states should have the power to tax worldwide income regardless of the jurisdiction to which additional taxes are paid, based upon the states’ powers under the Due Process Clause in the Constitution.

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6 Slip Op. at 18-19. The Court noted that it must consider three taxes that are labelled as different taxes as one tax: In order to apply the internal consistency test in this case, we must evaluate the Maryland income tax scheme as a whole. That scheme taxes three separate categories of income: (1) the “county tax” on income that Maryland residents earn in Maryland; (2) the “county tax” on income that Maryland residents earn in other States; and (3) the “special nonresident tax” on income that nonresidents earn in Maryland. For Commerce Clause purposes, it is immaterial that Maryland assigns different labels (i.e., “county tax” and “special nonresident tax”) to these taxes. In applying the dormant Commerce Clause, they must be considered as one. Slip Op. at 21, n. 8.

7 Scalia Dissent, at 5-6.
8 Thomas Dissent, at 1.
9 Thomas Dissent, at 3.
Conclusion

The court has recognized that there is no distinction between corporations and individuals when it comes to the Commerce Clause. For most taxpayers, the Court's application of the dormant Commerce Clause to states in the Wynne situation will be a positive. Both the Court's opinion and the dissents make clear, however, that there can easily be “internally consistent” state tax schemes that result in double (or multiple) taxation for taxpayers and do not fall under a dormant Commerce Clause challenge. In that case, the taxpayer would not win from the Wynne decision.

The Wynne result is not as rosy for states, which may face considerable revenue loss by the requirement of giving a full credit for other state's taxes (without the cap that operates in terms of the foreign tax credit and prevents US credits for foreign taxes at rates that exceed the US tax rate and would thus reduce taxes on US source income with taxes paid to foreign countries). States will likely grapple with the Wynne decision for some time, to determine how best to handle this significant change in revenue from their residents.

■
POINT & COUNTERPOINT

Dynamic Scoring: What Economic Modeling Can and Can’t Do Well

Introduction: In this Point & Counterpoint, Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation, Washington, DC; G. William Hoagland, Senior Vice President, Bipartisan Policy Center, Washington, DC; and Jane G. Gravelle, Senior Specialist in Economic Policy, Congressional Research Service, Washington, DC, reprise a panel discussion presented by the Teaching Taxation committee at the 2015 May Meeting. In the first point, Mr. Barthold discusses how the use of dynamic analysis permits the JCT to recognize that a tax policy change that is estimated to significantly change GNP will also affect the taxable base and thus tax revenues. In the second point, Mr. Hoagland explains how dynamic scoring adds additional information to the budget process and why it is here to stay. Dr. Gravelle provides the counterpoint by showing how the adoption of a single-point estimate for a dynamic scoring model that necessarily incorporates a variety of predictive assumptions provides a misleading picture of the likely responses to tax changes, especially when modeling assumptions are not transparent and inappropriate short-run and intergenerational effects are employed.

Click here to listen to the audio of this panel presentation.
Macroeconomics and Revenue Estimating at the Joint Committee on Taxation

By Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation, United States Congress, Washington, DC

The Joint Committee on Taxation (JCT) staff is nonpartisan and serves the entire Congress. One of the staff’s key responsibilities is to provide revenue estimates. These are estimates of the change in federal receipts that would result from proposed tax legislation. The objective is to produce accurate, consistent, and impartial revenue estimates that can be relied upon by members of Congress in making legislative decisions.

I. What Is a Revenue Estimate

A revenue estimate is an estimate of the change in projected federal baseline receipts that would result from a change in law. The reference point for a JCT revenue estimate is the Congressional Budget Office (CBO) 10-year projection of federal receipts, referred to as the “receipts baseline.” The receipts baseline serves as the benchmark for measuring the effects of proposed tax law changes. The baseline assumes that present law remains unchanged during the 10-year budget period. Thus, the receipts baseline is an estimate of the federal receipts that would be collected over the next 10 years in the absence of statutory changes. The JCT is required to estimate the revenue effects of proposals relative to the projected CBO receipts baseline.

A common misunderstanding that arises in reporting revenue estimates to policy makers is the distinction between a revenue estimate and receipts forecast. Generally, when the economy is growing, the CBO forecast of baseline receipts is growing. A negative revenue estimate of a tax proposal does not mean that the JCT is predicting receipts will fall. The negative revenue estimate means that receipts are predicted to grow more slowly if the proposal is enacted than they are projected to grow under present law in the baseline receipts forecast. Receipts would only decline if the revenue estimate predicted a loss in revenues that was greater than the underlying growth in baseline receipts.

II. Conventional Analysis

The JCT staff develops economic models to simulate future taxpayer behavior under the present law baseline and under the proposal to provide the Congress with estimated...
revenue effects. Each economic model is a theoretical construct representing economic processes by observable variables (using underlying economic data from a variety of sources) and a set of logical and quantitative relationships between the variables. There can be many different ways to model an economic problem. Models will differ in what features the modeler considers important and what features the modeler considers to be able to be ignored to make solution of the model practicable.

The JCT uses many different models.

- An individual tax model to forecast the effects on revenues from proposed changes in the individual income tax and from employment taxes. This model is based on data drawn from over 350,000 individual income tax returns supplemented with associated information returns and other data.

- A corporate model to forecast revenues from the corporate income tax. This model is based on ten years of data from every large domestic corporation and a random sample of smaller corporations.

- An estate and gift tax model to forecast the effects of proposed changes to estate and gift taxes. This model is based on estate and gift tax returns filed for a recent year and matched to income tax returns of the decedent.

- Separate models for each excise tax (as well as many other models for specific smaller taxes, credits, or exclusions).

These models are all microeconomic models. That is, they analyze behavior at the level of the individual taxpayer or individual business unit. They take as given the baseline projections of such macroeconomic variables as aggregate labor supply, aggregate investment, inflation, and the like. Press reports of JCT estimates of tax proposals are most commonly based on these microeconomic models. The JCT refers to this as “conventional analysis.”

A frequently expressed misconception about the JCT’s conventional revenue estimates is the notion that they assume taxpayers will not change their behavior in any way in response to tax policy changes. One of the conventions that both the JCT and CBO use for revenue and expenditure estimates is that they are done against a fixed forecast of aggregate economic activity. The JCT generally assumes that a proposal will not change total aggregate production and therefore holds forecasted Gross National Product (GNP) fixed. However, the JCT’s conventional revenue estimates are not “static” revenue estimates: they always take into account many likely behavioral responses by taxpayers to proposed changes in tax law. Such behavioral effects include shifts in the timing of transactions and income recognition, shifts between business sectors and entity form, shifts
in portfolio holdings, shifts in consumption, and tax planning and avoidance strategies, as follows:

- **Changes in the time of transactions and income recognition:**
  - Realization of capital gains in response to changes in the tax rates applicable to capital gains.
  - Issuance of corporate dividends in response to changes in dividend tax rates.
  - Changes in the composition of a taxpayer's total compensation between taxable income (e.g., wages) and non-taxed compensation (e.g., health benefits).
  - Acceleration of bonuses in anticipation of an individual income tax rate increase.

- **Changes between business sectors or the legal form of doing business:**
  - Organizing as a partnership in response to rising corporate rates or falling individual tax rates.
  - Shift in investment from more heavily taxed sectors to more lightly taxed sectors.

- **Changes in types of portfolio investments:**
  - Shifts from bonds to stocks or vice versa in response to tax rate changes on interest, dividends, or capital gains.
  - Shifts from taxable to tax-favored savings investments.

- **Changes in the amount, types, and timing of consumption:**
  - Reduced consumption of items that experience an excise tax increase.
  - Increased consumption of goods that are tax-favored, such as employer-sponsored health insurance and mortgage indebtedness.

- **Tax planning and tax avoidance strategies:**
  - Use of foreign tax credits and income allocation rules.
  - Reliance on performance-based compensation in response to a corporate deduction limitation (sec. 162(m)).
Structuring of compensation to obtain capital gains rather than income taxed at ordinary rates.

To summarize the JCT's conventional revenue estimating methodology: the JCT provides estimates relative to baseline receipts projected for future years under present law, not relative to receipts in years prior to the enactment of the proposal; the JCT generally assumes a fixed GNP forecast; and the JCT incorporates many types of microeconomic behavioral responses in its revenue estimates.\(^1\)

### III. Macroeconomic Analysis

Beyond raising funds for the federal government, members of Congress often intend for proposed tax policy changes to alter microeconomic behavior or to alter the future growth prospects of the economy. Conventional analysis generally addresses only microeconomic behavior: it does not account for possible changes in the underlying CBO macroeconomic projections.

Beginning in 2003, House Rule XIII(3)(h)(2) has required the JCT to provide a macroeconomic impact analysis of all tax legislation reported by the Ways and Means Committee. In early 2015 the House of Representatives modified its rules to require a single point estimate for the 10-year budget period of the deficit effect due to the macroeconomic response to certain “major” legislation. The new rule also requires qualitative analysis for 20 years after the budget period. With the adoption of the Concurrent Resolution on the Budget for Fiscal Year 2016, the Senate has adopted a comparable rule.

Over the past decade, the JCT has used several different models to simulate the macroeconomic effects of changes to tax policy to account for the sensitivity of the analysis to different modeling assumptions and frameworks. The JCT has used three different

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\(^1\) Descriptions of the JCT staff's conventional estimating models may be found in Joint Committee on Taxation, Testimony of the Staff of the Joint Committee on Taxation before the House Committee on Ways and Means Regarding Economic Modeling (JCX-46-11, September 21, 2011); Joint Committee on Taxation, Estimating Changes in the Federal Individual Income Tax: Description of the Individual Tax Model (JCX-75-15, April 24, 2015); and other documents at [www.jct.gov](http://www.jct.gov) under “Estimating Methodology.”
general equilibrium models: the macroeconomic equilibrium growth model (MEG), an overlapping generations lifecycle model (OLG), and a dynamic, stochastic general equilibrium growth model with infinitely lived agents (DSGE).

These three models share similar neoclassical economic foundations. In MEG and DSGE, consumption is modeled according to stylized life-cycle consumption patterns. That is, it is assumed that people adjust savings and labor such that their consumption fluctuates less over time than income might. In OLG, the life-cycle consumption pattern is more explicitly modeled with separate decisions by 55 different cohorts. Labor-supply decisions change with changes in the marginal and average changes in after-tax wages. Saving and consumption respond to after-tax returns to saving and after-tax income. Business investment responds to expected return to investment and to after-tax cost of capital, which in part depends on availability of savings. While sharing these common features, the three models differ in the types of simplifying assumptions they make in some dimensions in order to more carefully examine economic outcomes in other dimensions.

A. Macroeconomic Equilibrium Growth Model (MEG)

In the MEG model the availability of labor and capital determines total national output in the long run. Prices adjust so that demand equals supply in the long run. In the short run, resources may be temporarily under-employed or over-employed as people and businesses adjust to outside changes in the economy.

In the MEG model, labor-supply responses to changes in after-tax wages (elasticities) are separately modeled for four different groups:

- High-income primary earners;
- High-income secondary earners;
- Low-income primary earners; and
- Low-income secondary earners.

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2 The Joint Committee staff currently leases a version of this model from Tax Policy Advisors, LLC. Descriptions of the MEG and OLG models may be found in: Joint Committee on Taxation, Macroeconomic Analysis of Various Proposals to Provide $500 Billion in Tax Relief (JCX-4-05, Mar. 1, 2005), and Joint Committee on Taxation, Overview of the Work of the Staff of the Joint Committee on Taxation to Model the Macroeconomic Effects of Proposed Tax Legislation to Comply with House Rule XIII.3(h)(2) (JCX-105-03, Dec. 22, 2003). An updated description of the values of their key parameters may be found in Joint Committee on Taxation, Macroeconomic Analysis of the Tax Reform Act of 2014 (JCX-22-14, Feb. 26, 2014), at Appendix.

3 A description of the DSGE model may be found in Joint Committee on Taxation, Background Information about the Dynamic Stochastic General Equilibrium Model Used by the Staff of the Joint Committee on Taxation in the Macroeconomic Analysis of Tax Policy (JCX-52-06, Dec. 14, 2006).
Household saving and consumption are assumed to respond to the after-tax return to saving and after-tax income. Business production and housing production are modeled separately, and investment responds to changes in the user cost of capital.

MEG is an open economy model. Accordingly, cross-border capital flows and changes in net exports affect domestic economy outcomes.

Individuals in MEG are myopic. They do not anticipate changes in the economy or government policy.

B. Overlapping Generations Lifecycle Model (OLG)

Unlike the MEG model, the OLG model assumes that prices adjust to any changes in economic conditions (such as a change in fiscal policy) so that supply equals demand in every period and resources are always fully utilized after accounting for the cost of adjusting the capital stock. The model does not allow for unemployment. There is explicit modeling of international trade in goods and services, allowing for investments in tangible and intangible capital both in the United States and abroad.

In the JCT’s OLG model, economic decisions are modeled separately for each of 55 adult-age cohorts. It is assumed that each cohort makes decisions about consumption and savings, including the amount of leisure to consume, based on changes in after-tax wages as well as the after-tax return to savings.

The OLG model has separate production sectors for business and housing. Investment in the business sector responds to the expected future value of the firm as determined by the after-tax return to capital. Investment in the housing sector responds to the expected after-tax return to housing investment as well as to the consumption value of housing.

International capital flows are modeled through a separate “multinational” sector that models flows of investment and output between domestic firms and their foreign subsidiaries, as well as flows between foreign firms and their U.S. subsidiaries.

OLG is a perfect foresight model, in that individuals in each period are presumed to have information about future fiscal conditions and their decision-making is affected by those conditions.

C. Dynamic, Stochastic General Equilibrium Model (DSGE)

Unlike the MEG and OLG models, a significant feature of the DSGE model is that it attempts to account for uncertainty in economic decision making. Taxpayers examine all possible states of the future economy. For example, an increase in volatility of future asset returns is assumed to change the investment decisions of taxpayers in the DSGE model.
When policy variables are given stochastic or random components, the DSGE model provides the JCT staff with implications that the MEG and OLG models will not.

In the DSGE model, supply equals demand in the short run and in the long run. Consequently, there is always full employment. However, the model includes “sticky” prices and adjustment costs that cause output to be more sensitive to demand.

DSGE does not model international capital flows. It is assumed that all economic activity is contained within the U.S. economy.

Economic decisions are modeled separately for savers and non-savers. Non-savers do not own capital assets and have no access to the credit markets. Non-savers are generally lower income taxpayers. Non-savers may respond to tax policy changes differently than savers.

Decision-makers in DSGE make decisions based on rational expectations of future fiscal conditions. They can observe an array of possible future conditions; but because the model includes uncertainty, they do not have perfect information about the future path of the economy.

IV. Conclusion

The JCT uses its detailed microsimulation models, starting from the conventional estimates of a proposed tax change, to calculate changes in after-tax wages, after-tax rates of return to saving, and the user cost of capital. These calculated changes become inputs to the macroeconomic models to determine the possible effects that a proposed change in tax law may have on macroeconomic outcomes. Generally, if a tax policy significantly changes GNP, that change would affect the taxable base and thus tax revenues. Taking these effects into account is what many commentators refer to as “dynamic analysis.”

Under the Concurrent Fiscal Year 2016 Budget Resolution, the JCT reports the estimated effects of the proposed legislation and then reports an additional year-by-year projection of the effects on Federal receipts from the projected increase or decrease in U.S. GNP that is projected by the JCT’s macroeconomic analysis.

The JCT continuously works to make sure that our models reflect the most recent data and economic research. For example, over the past few years the JCT has added a more detailed international trade sector to the OLG model, distinguishing the location of tangible
capital investments from the location of investments in intangible assets. The JCT is exploring adding another business investment sector to the MEG model and further refining labor-supply responses for low-income, middle-income, and high-income primary and secondary earners.

POINT: Dynamic Scoring adds additional information to the budget process and is here to stay.

Dynamic Scoring: Is It Much Ado About Something?

By G. William Hoagland, Senior Vice President, Bipartisan Policy Center, and Former Staff Director, U.S. Senate Budget Committee, Washington, DC

I. Introduction

Reforms to the federal budget process were advocated almost immediately following the enactment of the historic Congressional Budget and Impoundment Control Act (CBA) of 1974. Both significant reforms and lesser ones have been adopted over the 41-year history of the Act. Proposed reforms historically can be classified into two categories: (1) those designed to force a legislated fiscal outcome, and (2) those designed to improve the accuracy and credibility of figures used in the process.

The first category is reflected in legislation such as the Balanced Budget and Emergency Deficit Control Act of 1985 (also known as the Gramm-Rudman-Hollings Act) and its subsequent legislation, the Budget Enforcement Act of 1990 and the Budget Control Act of 2011. These laws set in place limits or targets on annual federal spending and deficits, subject to automatic procedures (e.g. pay-as-you-go or pay-go, and sequesters) to achieve targets should enacted policies fall short.

The second category is best exemplified by the Federal Credit Reform Act of 1990. It was designed to better reflect the impact of long-term credit programs on the federal budget versus—up to that time—cash-based accounting of credit programs.

Advocated as a method to improve the accuracy in scoring federal legislation, “dynamic scoring” was advanced by Republican-controlled congresses beginning in 1995. The drive to modify the long-standing conventional scoring that assumed that overall output remained
unaffected by the underlying legislative changes grew over the next two decades. The persistent push to “reform” culminated this year in two ways. First, a new House procedural rule (H. Res. 5) was adopted. Second, that House rule was subsequently carried into the Senate by the adoption of the FY 2016 Concurrent Budget Resolution (S. Con. Res. 11) that effectively applies the House Rule to Senate procedures. Both the House Rule and the Budget Resolution require the CBO and the JCT to incorporate the budgetary effects of changes in macroeconomic variables in major legislation considered in the 114th Congress. (See Box 1, following.)

Title III – Budget Enforcement

Section 3112. Honest Accounting: Cost Estimates for Major Legislation to Incorporate Macroeconomic Effects

(a) CBO and JCT Estimates – During the 114th Congress… estimates by the CBP under section 402…..or by the JCT to the CBO under section 201(f) for any major legislation…shall, to the greatest extent practicable, incorporate the budgetary effects of changes in economic output, employment, capital stock, and other macroeconomic variables…
(b)(1)... a qualitative assessment...In the 20-year fiscal year...
(b)(2)...identification of critical assumptions and source of data underlying estimate.
(c)(1)(A) in the Senate -- "major legislation" means … (before incorporating macroeconomic effects and not including timing shifts) in a fiscal year… (i)(I) 0.25 percent of VDP, (II) greater than $15,000,000,000 for a treaty, (ii) designated by (I) the Chairman of the Senate or (II) Chairman or Vice Chairman JCT;
(c)(1)(B) in the House (i)…..0.25 of GDP or designated...

Report Language: “In the Senate, these estimates would be provided for informational purposes only. In the House, the Chair …shall exercise the authority under (c)(1)(B)(ii).”

The nearly two-decade trek for advocates of dynamic modeling reflects the classic work of John D. Kingdon, a political scientist who demonstrated how advocates of reform adopt tactics to succeed over the long haul. Kingdon argued:

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5 JOHN D. KINGDON, AGENDAS, ALTERNATIVES, AND PUBLIC POLICY (Longman, Boston 2d Ed. 2011).
Advocates for change prepare for better times by softening up – repeatedly calling for adoption of the preferred policy. They attempt to connect their preferred policy to the series of policy problems that seriously concern decision-makers. They explain the preferred policy’s mechanism for reducing those problems, supporting their claims of expert analyses. They modify their preferred policy after listening to the concerns and objections voiced by those with the power to reject their proposals. They do all this not in expectation of immediate success, but in hopes of being ready when political conditions are more favorable. At that time, their proposal might attain the heady status of ‘an idea whose time has come.’

Some analysts contend that dynamic scoring could significantly alter the projected cost of legislation, thereby giving a potential boost to some proposals that look more attractive when scored dynamically, while hurting the chances of others that may show larger deficit increases (or less deficit reduction). In reality, however, this scoring change will only be applied to a limited number of “major” pieces of legislation. … That said, those would also be some of the most consequential—and potentially controversial—bills that are considered.

II. Does Dynamic Scoring Matter?

For macroeconomic scoring, aka dynamic scoring, its time has come. What impact will it have on policy makers’ decision processes? Will it result in better information and therefore better legislation? How will it impact the consideration of legislation in the Congress? What will dynamic scoring really mean in practice? As the non-partisan referees of budget analysis, CBO and JCT’s scores carry substantial influence. Their cost findings can, and often do, make or break a piece of legislation. History is littered with legislation that might have passed if it had not scored poorly as increasing federal debt and deficits.

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applied to a limited number of “major” pieces of legislation. Major is defined as any legislation having a conventional score resulting in a change greater than 0.25% of GDP in any fiscal year (approximately $45 billion) or any direct spending (non-appropriations) legislation designated by the Chairmen of the two Budget Committees as major. That said, those would also be some of the most consequential—and potentially controversial—bills that are considered.

Because discretionary appropriations are controlled by aggregate spending limits currently set in law, the dynamic scoring analysis would not apply unless those limits are increased and the appropriations are clearly allocated for a specific purpose (e.g., infrastructure, education, national security) that triggers the rule’s 0.25%-of-GDP metric (e.g. $45 billion).

III. Experience to Date in the 114th Congress

Since the adoption of H. Res. 5 and S. Con. Res. 11, only one legislative item has been subject to the new scoring procedure—the Tax Relief Extension Act of 2015, reported ordered from the Senate Finance Committee on July 21, 2015. This legislation would extend tax provisions that expired in 2014 through December 31, 2016. Since extending the expired provisions would lower current law revenues by over $154 billion in 2016, this extender counts as “major” legislation. Three specific extenders—bonus depreciation, expensing of real property, and modifications of the research credit—account for the majority of the assumed revenue that would be lost under the bill. Over the ten-year scoring period, the extension of the expiring tax provisions was estimated to have a direct impact on increasing the federal deficit by $97 billion, but including the macroeconomic feedback effects (primarily, an assumption of an increase in capital stock) resulted in a $10 billion offset to the direct deficit estimated. Therefore, JCT estimated that the enactment of the extender bill would increase the deficit by $87 billion over the next decade, a 10% reduction in the impact calculated under the conventional estimating procedure.

A report requested by the Chairman of the Senate Budget Committee to estimate the budgetary effects of repealing the Affordable Care Act (ACA) provides a second example of the new dynamic scoring procedures following their adoption this year. The requested report, prepared jointly by the CBO and JCT, incorporated macroeconomic feedback. To date, however, no such legislation has been considered in the Congress. Over the ten-year

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7 Treaty legislation having a budgetary impact greater than $15 billion also would be considered major.
8 Joint Committee on Taxation, A Report to the CBO of the Macroeconomic Effects of the “Tax Relief Extension Act of 2015” as ordered reported by the Senate Committee on Finance (JCX-107-15, Aug. 4, 2015).
9 CBO, Budgetary and Economic Effects of Repealing the Affordable Care Act (June, 2015).
scoring period, the direct impact of a total repeal of the ACA was estimated to increase the federal deficit by $353 billion, but including the macroeconomic feedback effects (primarily, an assumption that the repeal would boost the supply of labor), the increase in the deficit over the time period was estimated to be only $137 billion. This represents a 60% reduction in the expected deficit compared to the result under conventional methodology.

IV. Conclusions from Experience to Date

Both analyses provide the first indication of how the CBO and JCT will apply the new estimating methodology.

Conclusion #1. Not surprisingly, the first simple conclusion from these two examples is that the CBO and JCT staff are equipped and prepared to estimate major legislation for the Congress with macroeconomic feedback effects. The staffs are prepared to provide useful information on the economic impact of major legislation which has not generally been available to legislators when considering major bills. Further, this is early in the process, and the presentation of the actual cost estimates using the feedback methodology will evolve over time.

In the case of the tax extenders bill, there was explicit inclusion of estimates of increases in capital stock, with resulting increased revenues. As estimated by the JCT staff, the primary effect of the bill on the economy would be an initial increase in the stock of business capital by 0.3% in the first half of the 10-year estimating period, resulting in an increase in production, output, and therefore receipts of 0.1% over the decade.

For the repeal of the ACA, the impact the legislation would have on boosting the supply of labor was also made explicit and suggested an increase in GDP that would not have been identified under the conventional scoring procedures. CBO estimated that the law’s repeal would raise economic output mainly by boosting the supply of labor, resulting in output increasing 0.7% over the next decade.

Conclusion #2. A more subtle but important conclusion from the two examples to date is that the estimates will be point or central estimates (not ranges) within a ten-year scoring window. As a result, the cost estimates with the macroeconomic impact will be applied to floor consideration of all major legislation both in the House and Senate, notwithstanding S. Con. Res. 11 report language explicitly stating that in the Senate the macroeconomic feedback effects would be for “informational purposes only.”
While indications of the magnitude of uncertainty surrounding the central estimate have been and will be highlighted in the cost estimates, for purposes of considering legislation in the two chambers the central estimate will apply for purposes of determining whether certain Budget Act points-of-order will apply. The central estimate is the last estimate to appear in a CBO cost-estimate and presents the legislation's impact including the macroeconomic feedback.

This is particularly critical in the Senate where a 60-vote point-of-order (e.g. pay-go) would lie against any legislation increasing the federal deficit. In the House of Representatives such points-of-order can be waived with a simple majority vote. The Senate Parliamentarian does not pick and choose between two estimates, but will look to one score and absent any precedent to date, it is highly likely that the last estimate in a CBO score, the “total estimated changes, including macroeconomic feedback” will be the one estimate used to determine procedural points-of-order. The first test of the new procedure will be joined this fall with the tax extender bill once it is brought to the Senate chamber.

**Conclusion #3.** A final conclusion, at least when applied to the two policies analyzed (e.g. extending expiring tax provisions, repealing the ACA), simply is that the positive macroeconomic feedback effects did not offset the larger negative effects of increased federal deficits and debt.

Advocates of dynamic scoring who might have expected that growth changes resulting from the new methodology would offset completely the conventional estimated deficit of the proposed legislation might be disappointed. At least as it relates to the two substantive items estimated to date, extending expiring tax cuts would still increase deficit projections, albeit less so than under conventional methodology. Further, repealing the ACA did not translate into a reduction in the deficit, though it lessened the conventional estimate.

Enactment of either the tax extenders or repeal of the ACA would today require legislators either to waive the point-of-order that presents an increase in the deficit or to find ways to offset the resulting deficit from the economic feedback scoring. Interestingly, those offsets, if included in the legislation, could “de-trigger” the rule or, if considered sequentially to the legislation, might be found to have negative economic growth effects under the new methodology.

The two proposals analyzed to date under the new rule need not be expository as it relates to the federal deficit. The comprehensive immigration bill passed by the Senate in 2013 would have significantly increased the U.S. labor force. When the CBO applied dynamic
scoring (prior to the adoption of this new procedure), it estimated a major reduction in the deficit of nearly $200 billion for the first decade after enactment.

V. Much Ado About Nothing?

No. Dynamic scoring is an important and valuable tool now added to the policy makers’ tool box. Dynamic scoring is here to stay. As demonstrated by its application to date, it will provide new insights into the broader economic impact of critical legislation. Legislators will be provided additional data to evaluate the merits or demerits of legislation. How they choose to use that additional information will vary depending on the underlying policy proposal. But it will not necessarily make their decision-making process easier or less political.

Achieving the shared goal of increased national growth will continue to require trade-offs and compromises within the political process, regardless of what estimating methodology is used.

COUNTERPOINT: Adoption of a single-point estimate for a dynamic scoring model that necessarily incorporates a variety of predictive assumptions provides a misleading picture of the likely responses to tax changes, especially when modeling assumptions are not transparent and inappropriate short-run and intergenerational effects are employed.

Issues in Dynamic Scoring

By Jane G. Gravelle, Senior Specialist in Economic Policy, Congressional Research Service, Washington, DC. The views in this article do not reflect the views of the Congressional Research Service.

I. Introduction

After many years of debate and a dozen years of providing advisory estimates on tax bills, dynamic scoring has been officially adopted in the U.S. Congress.

Conventional revenue and spending estimates are not static: they reflect numerous behavioral responses to changes. Conventional estimates, however, keep overall output (GDP) fixed, so they cannot consider changes due to increased labor and capital, and the
taxes on those induced earnings. Dynamic scoring allows the incorporation of these effects into cost estimates.

The first drive towards dynamic scoring began in 1995 when Republicans took control of the Congress. One of the first actions of the new Congress was to hold joint hearings on dynamic scoring.10 Subsequently, the Joint Committee on Taxation (JCT) convened a group of modelers to study dynamic scoring.11 In 2003, House rules required macroeconomic analysis of tax proposals and both JCT and the Congressional Budget Office (CBO) produced the first of a series of dynamic analyses that year.12

House Resolution 5, adopted in January 2015, provided rules for the House of Representatives for the 114th Congress. It requires incorporation of macroeconomic effects in official scoring of spending and tax legislation (excluding appropriations bills) reported by a committee. The scoring rule applies to legislation with an annual budgetary effect of at least 0.25% of projected GDP or as requested by the Chair of the Budget Committee for spending measures or by the Chair/Vice Chair of the Joint Committee on Taxation (the Chair of the Ways and Means Committee) for revenue measures. This rule supplants the previous requirement for an advisory macroeconomic analysis of tax changes, which usually presented a range of effects. Under the new House rule, macroeconomic effects are to be incorporated into official scores that drive budget rules associated with the budget resolution.

These rules were also included in the Budget Resolution for FY2016, S. Con. Res. 11. In the Senate, however, the dynamic estimates remain advisory and do not constitute official estimates.

The CBO prepares cost estimates for spending, while the JCT prepares estimates for tax measures. The CBO and JCT will continue to be responsible for each type of estimate and its feedback effect (the change in revenue or spending due to changes in the size of the economy).

The CBO, working with the JCT, presented the first dynamic score under the new regime for the repeal of the Affordable Care Act. That estimate was in response to a request from the Chairman of the Senate Budget Committee and not associated with a formal score for a

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10 Joint Hearing Before the House of Representatives Committee on the Budget and the Senate Committee on the Budget, 104th Congress, Review of Congressional Budget Cost Estimating (January 10, 1995).
piece of legislation. The JCT also presented a score for extending a number of temporary provisions that had expired.

II. Lack of Consensus

From 2003 to the present, advisory estimates reflected a wide range of effects, even varying in sign. Current rules require a point estimate, incorporated into official estimates in the House. If the first estimate produced (for the Affordable Care Act) is a guide, these new estimates will not quantify the assumptions made in arriving at estimates or providing sensitivity analysis, no longer providing information on the importance of alternative assumptions.

Four issues arise in estimating dynamic scores. The first issue is the types of effects to include and the time horizon to use. The second issue is the types of models to use. The third issue is the magnitude of behavioral responses built into the models. The fourth issue is the appropriate measure of the marginal tax rate.

The effects also occur (and can be larger) for appropriated spending, which is exempted from dynamic scoring. Including these effects in the modeling of tax cuts while not including them for appropriations would therefore favor tax cuts over increases in appropriations.

A. Types of Effects

Three types of effects may influence the feedback effect: (1) the short-run demand-side stimulus, (2) the crowding-out effect where the increase or decrease in the deficit reduces or increases funds available for investment, and (3) supply-side effects, where labor supply and savings respond to changes in tax rates. Demand stimulus effects arise from employing unemployed resources. They are transitory and positive for a tax cut. Crowding out is the effect of increased deficits in reducing capital available for private investments. (Crowding in arises from surpluses). This effect—negative for a tax cut—is small initially but grows continually over time. Supply-side effects are the effects on the supply of work, savings,


and investment from tax changes. They are generally positive for a tax cut and uncertain for tax reform. They are typically primarily due to labor supply in the budget horizon as capital takes some time to accumulate (unless investment flows from abroad).

A simulation of a $500 billion tax cut prepared by the JCT in 2005\(^\text{15}\) illustrates some of these short-term and long-term effects. In the case of an individual income tax cut incorporating all three effects, the revenue feedback effect (percentage reduction in cost due to macroeconomic effects) was 23%. If the short-run stimulus effect were eliminated, the feedback effect fell to 9.7%. If both stimulus and crowding-out effects were eliminated, the feedback effect was 13.5% (which is the supply-side effect). The stimulus and supply-side effects increased output, while the crowding-out effect reduced it. In the short run, with all effects, a 0.2% to 0.4% positive effect on output occurred in the budget horizon, but a 0.2% to 0.3% negative effect occurred in 30 years due to crowding out.

Even in the case of the estimates for former Ways and Means Chairman Dave Camp's Tax Reform Act of 2014 (H.R.1), which was roughly revenue neutral, demand-side effects were larger than supply-side effects.\(^\text{16}\) In the in-house macroeconomic equilibrium growth (MEG) model that accommodated all of these effects, the supply-side effects in the budget horizon were 0.1% to 0.2% of GDP (for the lower and higher labor-supply elasticities\(^\text{17}\)) but the demand-side effect was 0.3% of GDP.\(^\text{18}\)

Each effect has uncertainties. There is a case for eliminating short-run stimulus because these effects can be offset by actions of the Federal Reserve. Most of the economists testifying at the 1995 hearings either explicitly or implicitly indicated that demand-side effects should be excluded. The effects, at least in theory, also depend on how close the economy is to full employment. Moreover, estimates of the size of the stimulus (termed a “multiplier,” for how much each dollar of spending or tax cut is translated into additional dollars of output) vary substantially: for an individual tax rate cut, the high estimate is six


\(^\text{17}\) An elasticity is generally the percentage change in quantity divided by the percentage change in price (for a price or substitution elasticity) or divided by the percentage change in income for an income elasticity. A labor-supply response includes a substitution elasticity which is the percentage change in hours or participation divided by the percentage change in the net marginal wage, which rises when tax rates fall. This effect is assumed to increase labor supply with tax cuts. There is also an income response, which is assumed to cause labor supply to fall.

times the value of the low one. Moreover, the effects also occur (and can be larger) for appropriated spending, which is exempted from dynamic scoring. Including these effects in the modeling of tax cuts while not including them for appropriations would therefore favor tax cuts over increases in appropriations. Finally, and perhaps most importantly, these effects are transitory and are inappropriate for assessing the effects of a permanent tax change.

The extent of crowding out of investment depends on the amount of borrowing from abroad. Crowding out also occurs with spending. Crowding out is a longer run phenomenon and may not have much effect in the budget horizon, but it may be crucial to evaluating the long-run effects of a permanent tax change. Appropriations changes also produce crowding-out effects.

Supply-side effects vary depending on the model type and the magnitude of responses built into the model. Labor-supply effects occur quickly, while capital-stock effects occur more slowly, especially if arising from savings. Increases in the capital stock due to attracting capital from abroad may occur more quickly than those arising from savings. Positive supply-side effects may also occur with some types of spending, including appropriated spending (e.g., spending on infrastructure may increase productivity).

B. Types of Models

JCT and CBO use two basic types of models: a growth model (often called a Solow model) with labor supply and savings responses, and intertemporal models in which a representative agent optimizes choices for leisure and consumption over a lifetime (overlapping generations or OLG models) or over an infinite horizon. A Solow model is sometimes combined with a model that permits short-run stimulus effects, or a separate model may be used to measure those effects. Ideally, a model of international capital flows that takes into account feedback effects from the U.S. economy and the rest of the world would be incorporated to capture international capital flows. It appears, however, that the international model has not yet been fully developed.

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For the estimates of the three effects, JCT uses the MEG model that combines demand-side effects with a Solow growth model. In the 2005 study cited earlier, JCT reported an 11.3% feedback effect with an alternative (lower) measure of labor-supply response. JCT also uses an OLG model that can only account for supply-side effects. The feedback effect for the OLG model was 18.6%—about a third higher than the supply-side effect in the MEG model.

The structure of the OLG model is more theoretical, and this sometimes produces results that are difficult to verify empirically. In the OLG model, agents choose leisure and consumption over time by maximizing a utility function; supply effects flow from this process.

The intertemporal model is favored by some economists because of its theoretical purity. It cannot, however, capture demand-side or crowding-out effects. Since the model is forward looking, it must initially be solved for an infinitely long steady state. A change in the deficit in either direction is not possible (because it would lead to an infinitely large positive or negative asset position for the government). As a result, a tax change that affects the deficit cannot be modeled in isolation. Some other policy must always be taken into consideration—a spending change, a transfer, or a future tax change accompanying the estimate that offsets any deficit or surplus effects. The choice matters: each of these will produce a different result.

The pristine structure of the intertemporal model, admired by some, is also a straitjacket. For example, intertemporal substitution elasticities (percentage change in the ratio of relative consumptions divided by the percentage change in price\(^21\)) are the same whether periods are far apart or close together. There is no empirical evidence for the substitutability of consumption between periods that are far apart, but that response greatly influences effects if the proposal being evaluated changes tax burdens on capital income.

Intertemporal models in use assume a representative agent (in the case of the OLG model, a single agent per generation). Thus, unlike the MEG model, they cannot distinguish between the suppliers of labor and capital (i.e., workers and investors). This limitation can be important when estimating the effect of tax cuts: along with an incentive to work more because the marginal wage is higher, higher incomes cause both leisure and consumption to increase (and labor to decrease). The effect on labor supply depends on those offsetting effects, and the income effect may not be appropriately captured in an intertemporal model.

\(^{21}\) The price of future consumption at time \(t\) relative to time zero is \(1/(1+r)^t\), where \(r\) is the after-tax rate of return.
Because of the structure of the utility function in intertemporal models, direct labor-supply effects are not observed; instead, they are a function of a combination of parameters selected by modelers. Modelers do not always choose parameters that generate results consistent with empirical evidence. The model structure also makes labor supply responsive to the interest rate, something one modeler called “shooting in the dark.”

Open economy corporate models should respond to feedback effects from the rest of the world as well as from the U.S. economy. For example, if the corporate tax were lowered and international capital were mobile, some capital would flow into the United States from abroad and some would flow into the U.S. corporate sector from U.S. unincorporated sectors (including housing). These flows would likely reduce pretax returns in the U.S. corporate sector (where capital is now more abundant) but also have an effect in the U.S. noncorporate sector and in other countries. The flow of capital would eventually reach an equilibrium that reflects the mobility of international capital, the substitution between different products and the ease with which firms can substitute capital for labor. JCT and CBO do not have such a model. The Gravelle and Smetters model, which does contain a rest-of-the-world sector along with multiple sectors abroad and in the United States, suggests that even a large change in the corporate tax rate has negligible effects on output because of these effects.

Even the Gravelle-Smetters model, which has an extensive structure, does not fully account for the effect of lowering the corporate rate. Lower rates cause debt finance to be less attractive and reduce the inflow of debt finance. Thus, a corporate rate reduction could possibly lead to an overall contraction in the U.S. capital stock.

Open economy issues were quite important in determining the effects of the Camp tax reform proposal, the Tax Reform Act of 2014. The estimates showed a greater discrepancy between the supply side effects in the MEG and OLG models. Revenue feedback from supply side effects was $50 billion to $100 billion (increased GDP of 0.1% to 0.2%) over ten years in the MEG model, and almost $700 billion (increased GDP of 1.6%) in the OLG model. These larger differences may reflect, in part, an increase in the labor supply response in the OLG model (which may in turn be due to lack of an income tax base).

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24 Harry Grubert and John Mutti found that raising the tax on U.S. corporate capital increased the capital stock because debt is more mobile than equity. International Aspects of Corporate Tax Integration: The Role of Debt and Equity Flows, 47 NATIONAL TAX JOURNAL 111 (Mar. 1994).
effect and in part a new aspect of the OLG model that treats the shift in the ownership of intangible assets (e.g., patents and copyrights) due to changes in corporate taxes as having real effects on output. Since intangible assets can already be used costlessly in every location, this shift should not have an output effect. Similar issues were raised by William McBride of the Tax Foundation.26

C. Behavioral Responses

Within any given model, the magnitude of the behavioral response drives the result. The range of demand-side multipliers was discussed previously. However, there is also uncertainty not only about the magnitude but also about the direction of labor-supply effects because of income and substitution effects. Most estimates are small, but significant differences are reported. For example, in the JCT simulations of the Camp proposal, labor supply increased by 0.4% to 0.5% in the MEG model compared to 1.3% in the intertemporal OLG model. This difference is in small part due to a higher labor substitution elasticity, but it is probably largely due to the lack of income effects in the OLG model due to closing the model with transfers and not separating suppliers of labor from suppliers of capital.

Most of these models use positive elasticities net of income and substitution effects so that labor supply grows with wages. However, it is hard to accept any positive labor-supply response since increases in real wages over a long period of time did not produce an increase in the week.

In addition, empirical estimates of responses of many types, including those in intertemporal models that also capture substitution of consumption and leisure over time, may be overstated due to publication bias. When a statistical estimate finds a result contrary to theory, it is difficult to get that study published. Since there is a distribution across samples of effects, cutting them off at zero biases the body of estimates. For example, a study found that one type of elasticity—the short-term substitution between consumption in different periods—fell from 0.5 to between zero and 0.2 when a correction was made based on data that was sufficient to estimate the distribution including missing studies.27


As noted above with the introduction of open economy elements in the OLG model, new and untested innovations in behavioral effects can be significant. The “firm specific capital” substitution in the JCT’s OLG model for the Camp proposal was a large part of the difference between an output effect of 0.2% and one of 1.6%. This substitution effect was assigned a very high elasticity. If behavioral effects are incorporated in official scores, it is especially important to vet these sorts of innovations in modeling. This innovation is questionable not only with respect to its magnitude, but also regarding its existence. A change in the ownership of intellectual property should have no effect on real output in different locations. Lipitor™ is made from the same formula whether the patent is in Ireland or the United States.

D. Marginal Tax Rates

There is a need for more work on modeling marginal effective tax rates with tax reform. Base-broadening provisions that are part of tax reform can have marginal effects. Many of these associated with investment, such as slowing depreciation, have long been recognized, as have phase-outs in tax rates. Individual base broadening that increases the share of income being taxed (e.g. by eliminating itemized deductions) has not been incorporated, and these effects need to be captured. In general, because of these effects of base broadening, it is difficult to design a revenue-neutral, distributionally neutral tax reform that increases output.28

III. Issues Going Forward

The Senate Budget Resolution states in section 3112(b)(2) that the macro estimates include “an identification of the critical assumptions and the source of data underlying that estimate.” While the recent CBO/JCT analysis of the Affordable Care Act was not a formal score of a bill, it may be a guide as to what to expect from a dynamic score. Regrettably, it did not include critical assumptions. JCT estimated the effects of the non-insurance-related provisions, but it did include the effects of the Cadillac tax on high-cost insurance plans. CBO estimated the effects of insurance-related provisions. The study indicated that short-run demand effects were included and that Solow models would be used for supply-side effects. Although the study referred to previous papers, it did not report the precise multipliers or the precise labor-supply responses actually used. In particular, JCT has never reported its demand analysis in the form of multipliers. JCT uses two labor-supply elasticities (a high and low elasticity), but provides no indication which one is used in the study. The CBO labor-supply elasticity is twice the size of the high JCT labor-supply elasticity. Were different elasticities used for different parts of the analysis? It is not possible

to tell from the information in the study. These examples demonstrate the importance of greater transparency as an issue going forward.

Another issue that arose in the analysis of the Affordable Care Act that needs to be considered in the future is its use of short-term stimulus effects, which are questionable. It did not, however, employ intertemporal models (although that may not be the case in the future).

Similar points can be made about the recent JCT score for extending expiring tax provisions. This score also included short-run effects. While in this case information was provided on labor-supply responses and other parameters, no sensitivity analysis or estimates of inputs were available to understand what was driving these responses. The estimate followed the Affordable Care Act precedent in not employing intertemporal models.

Aside from these issues of lack of transparency in methodology, improper use of short-run stimulus effects, and potential improper use of intertemporal models, there remain a number of issues of concern. Dynamic scoring cannot provide a reasonable basis for analysis without correct measurement of the marginal effective tax rates. To be useful in judging the impact of tax changes, dynamic scorers need to prepare longer run estimates. Single-point scoring is more misleading than informative, given the many assumptions that can have dramatic effects on results: therefore, it is important that dynamic scoring provide ranges of effects with transparency about the various assumptions used. Finally, dynamic scoring of the economy cannot be adequately presented without construction of a full-scale corporate model with a rest-of-the-world sector.
PRO BONO MATTERS

Partnering for Pro Bono

By T. Keith Fogg, Harvard Law School, Legal Services Center, Jamaica Plain, MA, and Andrew R. Roberson, McDermott Will & Emery, Chicago, IL

The Pro Bono and Tax Clinics Committee has undertaken a new initiative designed to match law firms with low-income taxpayer clinics (LITCs) in need of assistance. This article describes the initiative in the hope that it might inspire some law firms to join and to let everyone know of the concept and the rationale for matching firms with remote clinics.

Several barriers face clinicians working in LITCs. For an overview of the development of LITCs and how many of these barriers came into existence, please see “Taxation with Representation – A History of Low Income Taxpayer Clinics” and “Tax Issues Facing Clients of Legal Services.”1 Although the movement started in academic clinics led by tax academics, the landscape changed with the passage of section 7526, which created a grant to fund the development of LITCs. That grant freed LITCs from their primarily academic setting and set them on a path to having most clinics housed in legal services organizations. In addition, independent clinics—not affiliated with either an academic institution or a legal services organization—now operate almost as many clinics as the academic community.

The change in the situs of LITCs has dramatically changed the operating model. In many LITCs, only one person provides substantive tax assistance. That person generally does not have the background of most academic clinicians, the resources of a university, or colleagues steeped in tax knowledge readily available. Many of those who serve as the tax professional for an LITC did not work in the area prior to directing the LITC. If they work in a legal services organization, their supervisors will almost never have a tax background. Consequently, many clinicians operating in LITCs must learn tax on the job without a mentor at their workplace.

In addition to the difficulties many clinicians face in learning the substance and procedure of tax, many clinics operate in states without a large tax bar. Clinics in these settings have difficulty creating pro bono panels, and the clinicians have difficulty finding local practitioners who might serve as mentors. In contrast, large cities around the country like Washington and New York have many firms with large and sophisticated tax practices and

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many experienced tax practitioners. The goal of the Committee's initiative is to match firms in large cities with clinics in more remote areas where there is a greater need for assistance in mentoring clinicians and providing competent pro bono services.

The initiative may also address a third component of need that exists for many LITCs. Section 7526 requires that an LITC obtain matching funds in order to receive a grant. The matching funds can come from a combination of cash and in-kind donations. The in-kind donations can include the value of the time of attorneys who provide pro bono services to an LITC's clients. By matching more remote LITCs with law firms from larger cities, the LITCs’ ability to find matching contributions may increase, allowing the programs to obtain larger grants and serve more taxpayers in need.

The idea for the initiative grew out of an Access to Justice panel that kicked off the Tax Court Judicial Conference in May 2015. During the panel, Andy Roberson (current Chair of the Pro Bono and Tax Clinics Committee) discussed ways in which his firm, McDermott Will & Emery, assisted low-income individuals and LITCs throughout the country and how there were similar opportunities for other law firms. The materials included a recent article entitled “A Calendar Call Staffing Success Story,” written by myself and Andy, which appeared in the Tax Section's NewsQuarterly (Winter 2014). The article describes Andy’s experience traveling to Hawaii to ensure pro bono services were available at the calendar call and ultimately trying a case on the spot on behalf of a low-income taxpayer. After the panel and during the remainder of the conference, partners from several law firms approached Andy to discuss how their firms might be able to get more involved in assisting low-income individuals in tax disputes.

After several firms expressed interest at the conference, the Pro Bono and Tax Clinics Committee approached the IRS LITC Program Office with a proposal to create a Partnering for Pro Bono initiative. The idea behind the initiative was to create a program similar to the current Adopt-A-Base program, in which pro bono volunteers provide tax training to military personnel through the “adoption” of a military institution in their geographic location. The Tax Section and many law firms have embraced the Adopt-A-Base program. It has grown over the past few years from a program serving a handful of bases to one that now serves dozens of bases across the country. The success of that program and the success of the Calendar Call program demonstrate the willingness of Section members to support pro bono efforts to improve access to assistance. This initiative seeks to build on the success of these earlier programs.

The LITC Program Office embraced the idea because it knew of the difficulties that some clinics had in training new clinicians, finding pro bono panelists and obtaining matching contributions. As a first step, the LITC Program Office and the ABA Section of Taxation are looking for LITCs that would be interested in participating. A message went out to all LITCs on September 15, 2015, asking for statements of interest. Within the first few days, 37 LITCs had requested assistance through the program, and expressions of interest continue
to come into the program office. The Committee hopes to have enough commitments to
the program to create a match between each of the LITCs in need and firms willing to
assist.

Direct pro bono representation of individual clients with controversies, like Andy Roberson
did in Hawaii, is not the only way that participating law firms can assist LITCs. They can
also serve as mentors, consultants, and advisers. They can strategize with LITC
practitioners about case work and tax practice. They need not even be located in the same
geographic region as the LITC with which they are matched—this initiative is intended to
provide pro bono assistance and opportunities throughout the country to those in need.

If your law firm would like to participate in this program, please contact ABA Section of
Taxation Pro Bono Counsel Derek B. Wagner at 202-442-3425
or derek.wagner@americanbar.org. If you have questions about the program, please feel
free to contact Andy Roberson at 312-984-2732 or Aroberson@mwe.com or Keith Fogg at
617-390-2532 or kfogg@law.harvard.edu. We welcome your interest and active
participation in this newest pro bono initiative.
YOUNG LAWYERS CORNER

Fifteen for the History Books: The Creation of a Law Student Tax Challenge

By Anne-Marie Rábago, California Western School of Law, San Diego, CA; Chair, Young Lawyers Forum

Introduction: This article is adapted from “Why A Law Student Tax Challenge?”—a Young Lawyers Forum panel discussion between Joseph Barry Schimmel and Clayton H. Collins held at the 2015 Joint Fall CLE Meeting in Chicago, IL.

“"You have to know the past to understand the present." - Carl Sagan

In the early fall of 2000, Richard M. Lipton, then Chair-elect of the Section of Taxation, met with Howard Engels to discuss the Arthur Anderson Annual Tax Challenge, a regional and national federal tax planning competition for graduate and undergraduate accounting students. For the Section, recruiting young tax lawyers and law students interested in tax practice had become a priority. Arthur Anderson’s success with visibility, outreach to accounting students, and employee recruitment proved their competition to be a model program. By October, Richard presented the idea of a “Law School Challenge” in a memorandum to Section Chair Pamela F. Olson and the Officers and Council of the Section. The Law Student Tax Challenge was born.

There were two purposes served by this new tax competition. The first was to get young tax lawyers involved with the Section. It was determined that the Section's newly established Young Lawyers Forum (YLF) would be charged with developing the competition. There were
young tax lawyers among the ranks of the Section, but many more would be needed to develop, administer, and run a successful competition. To this end, the YLF reached out to the ABA’s Young Lawyers Division, which had a standing tax committee, for support. The second purpose was to attract more students to the practice of tax law by engaging them while in law school.

The next question was: What kind of competition should it be? Barry Kozak, then Vice-Chair of YLF, had been involved with the Albert R. Mugel National Tax Moot Court Competition at SUNY Buffalo Law School. Joseph Barry Schimmel, a YLF organizer, had been involved with The Florida Bar’s National Tax Moot Court Competition. They questioned whether a moot court style competition was truly the best format for getting people interested in tax practice and opted to identify another way to structure the competition.

Joseph met with Professor Elliott Manning at the University of Miami School of Law to discuss alternatives. They came to the conclusion that the competition should be a transactional planning problem designed to focus on the tax consequences of a complex business planning problem. In “real life,” most tax lawyers are transactional. A client brings a tax problem or situation that needs a solution. The partner tells the young associate lawyer what the partner needs, and the associate comes back to the partner with research, answers, and ideas. The associate hopes the partner is content to have the associate discuss the ideas and findings with the client. Essentially, this became the format for the Law Student Tax Challenge (LSTC)—a transactional planning and client counseling competition—the first of its kind.

The YLF organizers then split into different committees to handle different aspects of the competition, including marketing, rule making, problem drafting, and judge recruiting. Planning the first LSTC was overwhelming. No one had heard of the LSTC, so an aggressive marketing plan was needed. Would marketing through the ABA Law Student Division suffice? Would contacting tax professors be more fruitful?

In addition, no rules existed for this type of competition. So, the organizers started with rules from a moot court competition to identify the issues that had to be addressed in the LSTC rules such as who would be eligible to compete; who would receive the awards—the law school or the student; should coaches be required; if so, what would they do. No one had ever done this type of competition for law students. There were no transactional competitions. The problem-drafting committee researched the substance and assignment
types found in J.D. business tax courses and used this information to structure the first LSTC problem.

From the beginning, the plan was for this competition to have both a written component and an oral presentation round. The benefits of a written competition were that an unlimited number of students could participate and the program could have maximum impact. In addition, the Section wanted to create a stronger connection with the most promising law students. An in-person, oral presentation round would provide the interaction that was seen as key to the successful results of Arthur Andersen’s model.

Fifteen teams from 14 law schools entered written submissions for the inaugural LSTC in the fall of 2001. On January 18, 2002, during the Section's Midyear Meeting in New Orleans, LA, the top four J.D. teams presented their solutions before a panel of judges including some of the nation's top tax professionals. A member of the runner-up team in that inaugural LSTC, Michael M. Lloyd, would become Chair of the LSTC two years later and a John S. Nolan Fellow the following year.

After four years of increasing success and popularity, the Section added an LL.M. Division to the competition in 2005. That year, 37 J.D. and 8 LL.M. teams competed. The 2010 LSTC set the record for most entries with 95 J.D. and 31 LL.M. teams. Many LSTC winners and participants have gone on to serve as leaders and significant contributors to the Section. According to Richard and Joseph, who were there at the beginning, the LSTC has achieved the purposes it set out in 2000 and gone far beyond what was ever imagined.

Teams for the 15th Annual LSTC are forming now. Information about the competition is available online. The deadline for written submissions is November 6, 2015. The authors of the best written submissions will present their solutions orally to a panel of judges in an open forum at the Section's 2016 Midyear Meeting in Los Angeles, CA. If you are planning to attend the Midyear Meeting, please drop by the LSTC oral rounds to support the YLF and our LSTC competitors.
UPDATE ON ABA RESOLUTION 101

Remarks of Section Delegate Richard M. Lipton
Before The ABA House of Delegates Regarding
the Tax Section’s Withdrawal of Resolution 101
August 3, 2015

I rise to withdraw Resolution 101. I want to more fully explain why the Tax Section has decided to withdraw this resolution.

This resolution relates to the regulation of tax return preparers under Circular 230, which is published by the Treasury Department. Circular 230 has provided for the regulation of persons appearing before the Treasury for over 120 years. In 1982 and 2009, this House adopted resolutions which opposed federal regulation of lawyers, but there was an explicit exception for pre-existing regulations, which was believed to encompass Circular 230.

The scope and validity of Circular 230 were challenged in the Loving and Ridgely decisions, and the Tax Section believes that it is important to acknowledge this regulatory authority, which is important to the effective functioning of the tax system. Resolution 101 contained two resolved clauses, the first of which called for the regulation of non-lawyers in tax return preparation and the second of which related to the regulation of lawyers under Circular 230.

Three objections were raised to the second resolved clause. The first objection was that lawyers who only occasionally prepare tax returns, such as solo and small firm practitioners, should not be regulated. We find this argument unpersuasive. Indeed, if anything, the lawyer who only rarely ventures into the tax arena is most in need of education and regulation. Following the logic of this argument, if I, an Illinois lawyer, wanted to appear in court in Indiana only once a year, the Indiana courts should not have any authority to regulate me because of the sporadic nature of my appearances in Indiana. If there is to be regulation in tax-related matters, it would need to apply to everyone.

The second argument was that regulation of lawyers in tax-related matters was unnecessary because the state bars regulate lawyers. As we explained in detail in the Report to Resolution 101, this argument does not apply to tax matters because of the confidential nature of tax return information. The federal government is prohibited by law from disclosing any details of a lawyer’s malfeasance in a tax matter to the state bar, other than
to simply state that the lawyer has been subjected to discipline under Circular 230. This law, which is found in section 6103 of the Internal Revenue Code, was adopted in response to abuses in the Nixon administration, and it effectively prevents the state bars from obtaining tax return information necessary to discipline a lawyer.

On a related note, some people suggested we address this issue by advocating a loosening of section 6103 to allow the federal government to inform the states about tax matters. We would strongly oppose revision to section 6103, which has worked for 40 years to preserve the confidentiality of all tax return information. Moreover, in light of allegations that the current administration has improperly used tax return information, it would be particularly troubling to have this Association support a loosening of those rules.

There was a third objection. Several individuals involved in representing the ABA in matters concerning regulation of lawyers pointed out to us the difficult position that Resolution 101 would place them in because they would be arguing for no federal regulation of lawyers in one area of the law while Resolution 101 proposed federal regulation of lawyers in another area. Even if there were good reasons for the distinction, it would be difficult for the Association to clearly and effectively deliver a consistent message that the ABA is opposed to federal regulation of lawyers.

We found this argument to be persuasive. The Tax Section is proud to be a part of the ABA, and we would never want to propose any action that would undercut other positions which are being maintained by the Association. Therefore, in a spirit of comity, we agreed to withdraw the second resolved clause in Resolution 101.

This would leave the first resolved clause, which calls for the regulation of non-lawyers involved in tax return preparation. Although there was no known opposition to this aspect of Resolution 101 in this House, it would put the Tax Section in a difficult position if the House were to adopt a resolution only related to non-lawyers. The Tax Section works regularly with the American Institute of Certified Public Accountants and other professional organizations in tax-related matters. It would be very awkward for the Tax Section to be urging the regulation of the members of all of these other organizations but not of our own members. Furthermore, we believe that the Treasury Department would not be impressed if the Tax Section was urging the regulation of everyone except tax lawyers. In order to retain our credibility with both the government and other professional organizations, if the second resolved clause must be withdrawn, the entire Resolution must be withdrawn.

Accordingly, the Tax Section withdraws Resolution 101.

A copy of the ABA Resolution 101 Report is available for download here.
TAX 

It Was Too Good to Be True
By Robert S. Steinberg, Law Offices of Robert S. Steinberg, Palmetto Bay, FL

(To tune of “Can’t Take My Eyes Off of You,” by Bob Crewe & Bob Gaudio and made popular by Frankie Valli.)

Verses

Sounded too good to be true
He said no tax would be due
Still I bought into his deal
Greed has a cunning appeal
With blinkers over my eyes
No tax for me was the prize
About this nothing is new
It seemed too good to be true

Well for two years it was grand
Just as that tax lawyer planned
Who knew that he was a crook?
Selling me gibberish
Till IRS trolled the facts
Telling me I owed the tax
Penalties now I owe too
It was too good to be true

Chorus

I should have told him
That he was full of crap
I should have told him
That I’m no shelter sap
But I didn’t tell him that

Should have known better
And recognized a kitsch
Should have known better
Swung for the sucker’s pitch
Should have known better
Tax lawyers all get rich

Verse

It seemed too good to be true
Taxpayers I’m warning you
Don’t fall right into the trap
Don’t be a tax shelter sap
Be wary of those who sell
In your head should ring a bell
Telling you caution is due
When it’s too good to be true.

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GOVERNMENT SUBMISSIONS

Boxscore

Since May 1, 2015, the Section has coordinated the following government submissions. A policy archive and comprehensive list of submissions are available at: http://www.americanbar.org/groups/taxation/policy.html.

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

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* 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.
GOVERNMENT SUBMISSIONS

Comments on the Definition of a Political Subdivision

Introduction: In the 2014-2015 Priority Guidance Plan, Treasury and the Service listed as a priority project to provide, "[g]uidance on the definition of political subdivision under §103 for purposes of tax-exempt, tax credit, and direct pay bond provisions." In relation to this project, the Section's Committee on Tax Exempt Financing sought to assist the government by providing input on the history of the definition of political subdivision as it relates to tax-exempt and tax-advantaged bonds. In particular, the Committee outlined the existing relevant authority and examined a 2013 Technical Advice Memorandum on this issue.

Principal responsibility for preparing these Comments was exercised by Mark Norell of the Section's Committee on Tax Exempt Financing. Substantive contributions were made by David Cholst, Matthias Edrich, James Eustis, Carol Lew, Scott Lilienthal, Vanessa Lowry and Victoria Ozimek. Assistance was also provided by Courtney Chen of the ABA's Law Student Division. The Comments were reviewed by Nancy M. Lashnits, Chair of the Committee, Stefano Taverna, Vice Chair of the Committee, John O. Swendseid, of the Section's Committee on Government Submissions. The Comments were further reviewed by Peter H. Blessing, the Section's Vice Chair (Government Relations).

As with all of its government submissions, the Committee's May 5, 2015, the Comments on the Definition of Political Subdivision to the Internal Revenue Service are available on the website at http://www.americanbar.org/content/dam/aba/administrative/taxation/policy/050515comments.pdf. The Executive Summary is reproduced in this issue of ABA Tax Times as a service to our members. —Jesse Tsai, Tax Section Staff Counsel, Washington, DC
EXECUTIVE SUMMARY

The following Comments are submitted at the request of the Internal Revenue Service (the “Service”), in connection with the 2014-2015 guidance project regarding the term “political subdivision,”¹ and at the request of the Office of the Tax Legislative Counsel, Department of Treasury. The Comments are also a follow-up to the May, 2014 meeting of the Committee on Tax Exempt Financing (the “Committee”) of the American Bar Association Section of Taxation (the “Section”).

For interest on a bond to be excluded from gross income for federal income tax purposes, the bond must be a “state or local bond” under section 103(a).² Regulation section 1.103-1(a), in relevant part, provides:

Interest upon obligations of a State, territory, a possession of the United States, the District of Columbia, or any political subdivision thereof (hereinafter collectively or individually referred to as “state or local governmental unit”) is not includable in gross income ….

Regulation section 1.103-1(b) further provides:

The term “political subdivision,” for purposes of this section denotes any division of any State or local government unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit.

The leading case that considered a predecessor version of the above Regulations, Commissioner of Internal Revenue v. Shamberg’s Estate (“Shamberg”),³ held that there are three elements of sovereign power: (1) the power of eminent domain, (2) the power to tax, and (3) the police power. Although Shamberg only required that part or a portion of those powers be present to conclude that an entity created under state law for a governmental purpose is a political subdivision, subsequent authorities indicate that

¹ Under the initial 2014-2015 Priority Guidance Plan, and the most recently published plan (the second quarter update), both available at http://www.irs.gov/uac/Priority-Guidance-Plan, there is a project listed in the Tax Exempt Bonds section for “Guidance on the definition of political subdivision under Section 103 for purposes of the tax exempt, tax credit, and direct pay bond provisions.”
² References to the “section” refer to the Internal Revenue Code of 1986, as amended (the “Code”); and all references to the Regulations refer to income tax regulations promulgated under the Code.
³ 144 F. 2d 998 (2d Cir. 1944), cert. denied, 323 U.S. 792 (1945). Commissioner v. White’s Estate, 144 F.2d 1019, 44-2 U.S.T.C. 710 (2d Cir. 1944), cert. denied, 323 U.S. 792, 65 S. Ct. 433 (1945) (“White’s Estate”) was a companion case to Shamberg and examined bonds issued by the Triborough Bridge Authority.
possession of only an insubstantial amount of any or all sovereign powers is not sufficient. From time to time, the Service has issued administrative guidance following Shamberg, elaborating on the amount and type of sovereign powers sufficient for such qualification. Thus, until recently the definition of a political subdivision has been understood to be settled and limited to the considerations set forth in Shamberg, with questions mainly arising as to whether an entity has sufficient sovereign powers to be a political subdivision.4

The definition of a political subdivision for purposes of tax-advantaged financings came back to the forefront in Technical Advice Memorandum 201334038 (the “2013 TAM”). The 2013 TAM addresses the status of a particular issuer (the “Issuer”) as a political subdivision. Parts of the 2013 TAM appear to set forth new substantive requirements not previously considered in the various statutory, administrative or judicial precedents. The 2013 TAM states that:

[the term “political subdivision” is defined in Reg. § 1.103-1(b) as “any division of any state or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit.”

... The phrase “division of a state or local government” must be read in the context of the purpose of Section 103, which is to provide subsidized financing for State and local government purposes. The Code permits the benefit of this subsidy to be passed on to private persons under some circumstances, but only if a governmental unit determines that the issuance of such bonds is appropriate. A governmental unit is inherently accountable, directly or indirectly, to a general electorate. In effect, Section 103 relies, in large part, on the democratic process to ensure that subsidized bond financing is used for projects which the general electorate considers appropriate State or local government purposes. A process that allows a private entity to determine how the bond subsidy should be used without appropriate government safeguards cannot satisfy Section 103.

The 2013 TAM concludes that because the Issuer is not directly or indirectly answerable to

4 A relatively succinct statement of the law is provided in the quoted language from GCM 36994 (February 3, 1977) set forth at part III.F of the Discussion below. The GCM goes so far as to state that “we consider the meaning of political subdivision for purposes of section 103(a)(1), to be well established.”
the electorate, it is not a division of a State or local government, and therefore it is not a political subdivision that may issue tax exempt bonds. The TAM points to the “division” language in Regulation section 1.103-1(b) to require “accountability, directly or indirectly, to a public electorate.” As discussed more fully herein, accountability has not previously been required to achieve political subdivision status and control has been analyzed as a factor in whether sovereign power has been delegated,

The Committee is concerned that auditors of tax exempt bonds may use the 2013 TAM to apply a new standard not based on existing law, thereby creating significant uncertainty in a well-established transactional practice that relies on unqualified tax opinions. Audits based on the new analysis in the 2013 TAM could have a substantial adverse impact on existing issuers and could prove costly to state and local governments. Moreover, although the 2013 TAM cannot be used as precedent, the mere presence of the quoted language in a published administrative determination creates uncertainty with regard to the standard to be applied by a tax lawyer, an issuer, or the Service when evaluating political subdivision status of an entity.

It is not the objective of these Comments to make any comment about whether the Issuer in the 2013 TAM qualifies as a political subdivision. Instead, in light of the new requirements that the 2013 TAM seems to impose to qualify as a political subdivision, we recommend that the 2013 TAM be withdrawn or modified to conform with existing precedent. The Committee also recommends that the Service and Treasury issue a notice providing interim guidance prior to the issuance of new political subdivision regulations and stating that any change to the definition of political subdivision will apply solely on a prospective basis.

The remainder of these Comments first provides a more in depth discussion of the 2013 TAM, second provides a review of existing law on the issue of political subdivision as it relates to the issuance of tax advantaged obligations, and, third, provides an analysis of existing law in the context of the 2013 TAM and new regulations addressing political subdivision status. ■
GOVERNMENT SUBMISSIONS


Introduction: On January 16, 2014, Treasury and the Service issued proposed regulations providing guidance on certain partnership provisions of the American Jobs Creation Act of 2004. The Section's Partnerships and LLCs Committee responded to the government's request for comments in the preamble to the proposed regulations with a series of recommendations concerning the contributions of built-in loss property, mandatory basis adjustment provisions, basis allocation rules under section 755, substituted basis transactions, and the application of layering versus netting in applying section 704(c).

Principal responsibility for preparing these Comments was exercised by Roger F. Pillow of the Section's Partnerships and LLCs Committee. Substantive contributions were made by Didi Borden, Robert J. Crnkovich, Jeff A. Erickson, Jonathan D. Grossberg, Michael Humphrey, Grace Kim, Bryan A. Rimmke, John J. Rooney, John G. Schmalz, James B. Sowell, and William S. Woods II. The Comments were reviewed by Jeanne Sullivan, Chair of the Committee. The Comments were further reviewed by Adam M. Cohen of the Section's Committee on Government Submissions, by Bahar Schippel, the Section's Council Director for the Committee, and by Peter H. Blessing, the Section's Vice Chair (Government Relations).

As with all of its government submissions, the Committee's May 7, 2015, Comments on Proposed Regulations on Certain Partnership Provisions of the American Jobs Creation Act of 2004 to the Internal Revenue Service is available on the website at http://www.americanbar.org/content/dam/aba/administrative/taxation/policy/050715comments-1.pdf. The Executive Summary is reproduced in this issue of the ABA Tax Times as a service to our members. —Jesse Tsai, Tax Section Staff Counsel, Washington, DC
EXECUTIVE SUMMARY

1. Background

The Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) issued proposed regulations (the “Proposed Regulations”) providing guidance on certain provisions of the American Jobs Creation Act of 2004 (the “AJCA”), conforming the existing regulations under sections 704(c)(1)(B) and 737 to statutory changes made by the Taxpayer Relief Act of 1997, modifying the existing basis allocation rules under sections 743(b) and 755 for substituted basis transactions, and providing additional guidance regarding allocations resulting from revaluations of partnership property.2

In the preamble to the Proposed Regulations, Treasury and the Service requested comments regarding specific issues. We appreciate the opportunity to provide comments both in response to these specific requests from Treasury and the Service and on other aspects of the Proposed Regulations.

2. Contributions of Built-in Loss Property

2.1. We recommend that Proposed Regulation section 1.704-3(f) specifically adopt the rule of Proposed Regulation section 1.704-3(a)(6)(iii). If the government intends to require a LIFO ordering rule in this situation, as is implied in an example in the Proposed Regulations, we recommend that the text of the final regulation be clarified to expressly so state.

2.2. Proposed Regulation section 1.704-3(f)(3)(iii)(A) provides special rules under which a section 704(c)(1)(C) basis adjustment is not eliminated if the pertinent section 704(c)(1)(C) partner transfers its partnership interest in a “nonrecognition transaction.” Neither the Proposed Regulations nor their preamble defines the term “nonrecognition transaction.” We believe that additional clarity could be achieved if the Proposed Regulations were modified to provide that the term “nonrecognition transaction” has the meaning set forth in section 7701(a)(45).

2.3. We recommend that the use of a section 704(c)(1)(C) basis adjustment to cure a ceiling rule limitation with respect to other property contributed by the section 704(c)(1)(C) partner be considered a reasonable method for purposes of section 704(c).

1 References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.

2.4. We recommend that Regulation section 1.704-3(a)(8) be amended to provide that when a partnership transfers section 704(c) property and other property to a corporation under section 351, the partnership should take a basis in a separate block of stock that preserves the aggregate built-in gain or loss that would be allocated to the relevant section 704(c) partner had the partnership disposed of the contributed property immediately before the transfer.

2.5. We recommend modifying the final regulations to allow the aggregation rules in Regulation section 1.704-3(e)(2) to be used in connection with the determination of a section 704(c)(1)(C) basis adjustment.

2.6. We recommend that the final regulations provide guidance illustrating that “attributable to” under Proposed Regulation section 1.704-3(f)(3)(iii)(B) means an amount of built-in loss that would have been allocated to a distributee-partner if an upper tier partnership had sold its built-in loss asset in an arm’s length transaction immediately prior to the distribution that occurs in a partnership merger or division (the “Tracing Approach”).

2.7. We recommend that the final regulations provide that, with respect to section 704(c)(1)(C) partners in a merged partnership, section 704(c)(1)(C) will continue to apply by reference to the resulting partnership in the same manner as section 704(c)(1)(C) applied with respect to the merged partnership prior to the merger.

2.8. We recommend that the final regulations provide a de minimis exception regarding the application of section 704(c)(1)(C) to partnership mergers and divisions similar to those in the 2007 proposed regulations relating to the anti-mixing bowl rules and assets-over partnership mergers.

2.9. We recommend that, in determining a distributee-partner’s basis in a distributed lower-tier partnership interest, the final regulations provide guidance that would allow the term “equitably apportioned” under Regulation section 1.61-6(a) to be defined as taking into account the partner’s share of gains or losses in the distributed lower-tier partnership’s interest (the “Tracking Approach”).

2.10. We recommend that the final regulations provide an elective rule that, in the context of the distribution transaction in a division, would permit the reallocation of any section 704(c)(1)(C) basis adjustment created in connection with the contribution of assets to the lower-tier partnership in the same way as if the assets were being distributed directly to the partners in the divided partnership.

2.11. If the immediately prior suggestion is not adopted, we recommend that the final
regulations provide a rule confirming that in a situation where the “conforming reductions” rule in Proposed Regulation section 1.704-3(f)(3)(iv)(B)(2) overlaps with the Deemed Section 754 Election rule, the “conforming adjustment” would be made first, and the Deemed Section 754 Election rule would be applied after the application of the “conforming reduction.” We believe that the final regulations should also provide an example illustrating the application of the “conforming reduction” rule in the context of a partnership division.

2.12. We agree with the rule of the Proposed Regulations that the non-contributing partner should not take section 704(c)(1)(C) basis adjustments into account under section 732. If a non-contributing partner took section 704(c)(1)(C) basis adjustments into account in applying section 732(f), losses might be inappropriately eliminated and additional gain might be inappropriately created. Accordingly, we recommend that the rule set forth in Proposed Regulations section 1.704-3(f)(3)(v)(B), (i.e., that a section 704(c)(1)(C) basis adjustment is not taken into account in applying section 732(f) upon a distribution of stock to a partner other than a contributing partner, be retained).

2.13. We recommend that existing Regulation section 1.743-1(g)(2)(ii) be amended, and that the Proposed Regulations be revised to allow taxpayers to reallocate sections 704(c)(1)(C) and 743(b) basis adjustments to remaining partnership property of a character similar to that of the distributed property with respect to which the adjustments arose under the principles of Regulation section 1.755-1(b)(5)(iii).

2.14. We recommend that a section 704(c)(1)(C) basis adjustment attributable to section 704(c)(1)(C) property hypothetically distributed to a non-section 704(c)(1)(C) partner under the existing section 751(b) regulations that is hypothetically reacquired by the distributing partnership in an exchange transaction with the distributee-partner should remain embedded with the section 704(c)(1)(C) property hypothetically distributed and reacquired by the distributing partnership under the current section 751(b) regulations.

2.15. We recommend that the Proposed Regulations or the Proposed Section 751(b) Regulations be clarified with respect to the interaction of sections 704(c)(1)(C) and 751(b) with respect to the Hypothetical Exchange Approach described in those Proposed Section 751(b) Regulations is adopted in final regulations for section 751(b).

3. **Mandatory Basis Adjustment Provisions**
3.1. We agree with the Proposed Regulations’ clarification as to the timing for a partnership’s determination of whether it has a substantial built-in loss being immediately after a transfer.

3.2. Subject to our comments herein as to certain subsidiary partnerships in a tiered partnership structure, we agree that the appropriate consequence of a partnership having a substantial built-in loss immediately after an interest transfer is to treat the partnership as having a section 754 election in effect only with respect to such transfer.

3.3. We agree that the determination of a substantial built-in loss for a partnership should be made without regard to any section 743(b) and 704(c)(1)(C) adjustments other than those of any relevant transferee-partner.

3.4. We agree with the Proposed Regulations’ gross up approach for purposes of determining an upper-tier partnership’s fair market value in a lower-tier partnership, but recommend that an example be provided to clarify the manner in which contingent liabilities of the lower-tier partnership are taken into account in determining the gross up amount.

3.5. Although we agree with the stated purpose of the Proposed Regulations’ section 743 substantial built-in loss anti-abuse rule, due to the multiple purposes that exist with the implementation of most commercial transactions, we recommend that any such section 743 anti-abuse rule be applicable only in a situation in which “the” principal purpose (as opposed to “a” principal purpose) of a transaction, or series of transactions, is to circumvent or avoid the purposes of the substantial built-in loss rules. We also recommend that final regulations provide specific examples of such principal purpose transactions, as well as clarification as to whether the results of the application of such an anti-abuse rule would be limited to the application of the section 743 substantial built-in loss rules.

3.6. We recommend that final regulations clarify whether an anti-abuse rule similar to that proposed for purposes of the section 743(b) substantial built-in loss rule would be applicable with respect to a section 734(b) substantial basis reduction and, if so, the situations in which such a rule would be applicable.

3.7. Proposed Regulation section 1.743-1(n)(7)(ii) provides than an upper-tier partnership is not considered engaged in a trade or business, and thus as not disqualified from being an EIP, if the upper-tier partnership owns an interest in a lower-tier partnership and, at all times, the adjusted basis of the upper-tier partnership’s interest in the lower-tier partnership is less than 25% of the total capital that is required to be contributed to the
upper-tier partnership (defined herein as the 25% Requirement). We recommend that debt allocations under section 752 by a lower-tier partnership to an upper-tier partnership be disregarded when determining whether the adjusted basis of an upper-tier partnership's interest in a lower-tier partnership is less than 25% of the total capital that is required to be contributed to the upper-tier partnership by the partners of the upper-tier. This recommended rule should apply without regard to where in the tiered structure a borrowing partnership is located.

3.8. We recommend that Proposed Regulation section 1.743-1(n)(8) be modified to include, as an exception to the Substantive Restriction Rule of Proposed Regulation Section 1.743-1(n)(6)(viii), an investor's holding an interest in an electing partnership that constitutes a prohibited transaction under ERISA.

3.9. We recommend that a partnership that has properly elected to be an EIP be permitted to cure a transitory failure to satisfy the terms set forth in section 743(e) and Proposed Regulation section 1.743-1(n). We also believe that any such transitory failure should be disregarded following the electing partnership's return to compliance if no interests in the electing partnership were transferred during the period that the electing partnership was out of compliance with the EIP rules.

3.10. We request that final regulations provide additional guidance regarding interest transfers in an EIP at a time that the EIP is not in compliance with section 743(e) and Proposed Regulation section 1.743-1(n). We recommend that the guidance require the non-compliant EIP to adjust the basis of its property as otherwise required by sections 743(b) and (d) with respect to each of its partners that acquired an interest in such partnership during the period that the EIP is out of compliance with sections 743(e) and finalized Proposed Regulation section 1.743-1(n).

3.11. We recommend that an EIP be permitted to disregard its transitory non-compliance with section 743(e) and Proposed Regulation section 1.743-1(n) and to compute and allocate its taxable income and loss as if it had been continuously in compliance with these provisions provided it cures its non-compliance by the time for filing its return for the year in which its non-compliance arose, including extensions.

3.12. We recommend that final regulations provide, as a general rule, that a re-electing EIP, i.e., an EIP that revoked its election with the consent of the Treasury but that subsequently re-elects to become an EIP, would be required to maintain and apply any basis adjustments under sections 743(b) and (d) that arose following its revocation of its EIP election and before its re-election of EIP status.
3.13. We recommend that final regulations clarify that a re-electing EIP can treat itself as having continuously been in compliance with an EIP election if either (i) there were no transfers with respect to which a basis adjustment under section 743(b) or (d) would have been required during the period between the partnership’s revocation and its re-election of EIP status or (ii) the partnership properly re-elected EIP status with its timely filed return (including extensions) for the year in which the Treasury’s consent for its revocation became effective.

3.14. We believe that requiring a lower-tier partnership to adjust the inside basis of its partnership assets when such partnership does not have a section 754 election in effect will be highly burdensome for many partnerships and that requiring a lower-tier partnership to make adjustments when it does not have a substantial built-in loss is beyond the intent of section 743(d) and is contrary to Rev. Rul. 87-115. Moreover, we believe that the proposal might create a fungibility concern for many publicly traded partnerships, which generally have to ensure that each partnership interest within a class of interests is fungible with any other interest in such class. If adopted, the proposal might require certain publicly traded partnerships to alter their current structures in a manner that would create administrative burdens as noted herein without promoting the purposes of the enactment of the mandatory basis adjustment rules.

3.15. We believe that it is beyond the plain meaning and purpose of section 743(d)(1) to require a lower-tier partnership to make an adjustment to the basis of its assets when it does not have a substantial built-in loss and has not had an actual interest transfer while a section 754 election is in effect.

3.16. If the final regulations require basis adjustments of properties held by a lower-tier partnership as a result of an event at an upper-tier partnership, we recommend that final regulations include guidance requiring the upper-tier partnership to provide the computational information that would be available only at the upper-tier partnership level but is needed at the lower-tier partnership level in order for such lower-tier partnership to make its required adjustments.

4. The Section 755 Basis Allocation Rules

4.1. Existing section 755(c)(1) implies that a basis adjustment might be prohibited from being made to the basis of certain equity interests in a non-corporate person. Because we believe that section 755(c) was intended to prevent basis reductions only to stock, we recommend that Treasury and the Service pursue a legislative technical correction to adjust section 755(c)(1) to state that no allocation may be made to a corporation’s stock directly
or indirectly owned by a partnership in which such corporation is a partner or to stock of a corporation that is directly or indirectly owned by such partnership and that is related (within the meaning of section 267(b)(1)) to a corporation that is a partner in such partnership.

4.2. Proposed Regulation section 1.755-1(e)’s disjunctive approach might be read to prevent an upper-tier partnership from making a negative basis adjustment to a lower-tier partnership interest in a situation in which the upper-tier partnership and the lower-tier partnership are related within the meaning of section 707(b)(1). Because we do not believe this is consistent with the purpose of section 755(c), to the extent that the above recommendation is not accepted and the existing section 755(c)(1) language is retained, we believe that the Proposed Regulations should confirm that the provision is only intended to prohibit basis reductions in stock of a corporate partner or a corporation that is related to such partner.

4.3. We recommend that the Proposed Regulations clarify that where a negative basis adjustment is allocable to “other partnership property” under Proposed Regulation section 1.755-1(e)(1)(B), the rules set forth in Regulation section 1.755-1(c) apply such that a negative adjustment must be allocated to partnership property of a character similar to that of the distributed property to which the negative adjustment arose.

4.4. We recommend that the Proposed Regulations clarify that the gain recognized under Proposed Regulation section 1.755-1(e)(2) should be allocated to the partners in the partnership in accordance with the general rules of section 704(b).

4.5. We request that the final regulations provide examples as to the interaction of sections 337(d), 755(c), and 732(f).

4.6. We agree with the changes proposed that would provide that if there is an increase in the basis to be allocated to partnership assets under Regulation section 1.755-1(b)(5), the increase must be allocated to capital gain property and ordinary income property in proportion to, and to the extent of, gross gain or gross income that would be allocated to the transferee from a hypothetical sale of all property in each class, while a decrease must be allocated between capital gain and ordinary income property in proportion to, and to the extent of, the gross loss that would be allocated to the transferee from a similar hypothetical sale of all property in each class.

4.7. We recommend that the finalized Proposed Regulations include an example of the proposed modification to Regulation section 1.755-1(b)(5)(iii)(C) and clarify that, to the
extent a transferee’s negative basis adjustment is made, the applicable partnership is responsible for tracking any excess adjustment under Regulation section 1.743-1(k).

5. **Succeeding to a Transferor’s Basis Adjustment – Proposed Regulation Section 1.743-1(f)(2) Substituted Basis Transactions**

5.1. The flush language of section 743(b) states that a basis adjustment under section 743 is an adjustment to the basis of partnership property with respect to the transferee partner only. Regulation section 1.743-1(j)(1) confirms that. The effect of Proposed Regulation section 1.743-1(f)(2) will often be that a transferee partner steps into the shoes of the section 743 basis adjustment of a transferor. We believe this result is inconsistent with both the statutory language and the existing section 743 regulations.

5.2. We believe that the Proposed Regulations prevent a basis shift only in situations where two factors are present: (i) the transferee’s basis in its interest is equal to the transferor’s basis in its interest and (ii) the transferor’s outside basis in its interest is equal to the sum of the transferor’s share of the inside basis of partnership assets and the transferor’s section 743 adjustment. There are several common situations in which one or both of these factors will not apply and a substituted basis transaction will often result in a basis shift. As a result, instances remain in which a partner might effectively elect out of the basis adjustment rules of Regulation section 1.755-1(b)(2) through (4) and into the substituted basis adjustment rules of Regulation section 1.755-1(b)(5).

5.3. The Proposed Regulations indicate that a positive basis adjustment for a transferee-partner is recovered as if it were newly placed in service property. This restart of the depreciable life appears inconsistent with the underlying theory of the Proposed Regulations in that the Proposed Regulations effectively treat a transferor’s section 743(b) basis adjustment as common inside basis for both the transferor and the transferee. If final regulations retain the rule set forth in Proposed Regulation section 1.743-1(f)(2), we believe the substantive language of the Proposed Regulations should be amended to make it clear that the transferee does not succeed to the remaining depreciable life associated with the basis adjustment.

5.4. The application of Proposed Regulation section 1.743-1(f)(2) should be clarified with respect to tiered partnerships. Specifically, the Proposed Regulations should clarify as to whether an interest in a lower-tier partnership is also treated as having been transferred in a substituted basis transaction when an interest in the upper-tier partnership is transferred in a substituted basis transaction.
5.5. In light of the questions raised herein regarding the authority for Proposed Regulation section 1.7431(f)(2) and the continued ability to avoid the electivity that Proposed Regulation section 1.743-1(f)(2) appears to target, we recommend that Treasury and the Service consider withdrawing Proposed Regulation 1.743-1(f)(2). If Proposed Regulation section 1.743-1(f)(2) is finalized, we recommend that Proposed Regulation section 1.743-1(f)(2) be modified so as to address the comments herein.

6. **Section 704(c): Layering Versus Netting**

6.1. We recommend that a partnership be permitted to use the netting approach where the parties agree to do so and the adoption of netting does not violate Regulation section 1.704-3(a)(10).

6.2. If the immediately prior recommendation is not adopted, we recommend that a partnership be permitted to use the netting approach where the gross value of the partnership’s assets is less than $20 million, adjusted for inflation, as of the date of any revaluation event.

6.3. We recommend that final regulations provide a grandfather rule that allows an existing partnership to continue using the netting approach if it has adopted a netting approach prior to the adoption of final regulations.

6.4. We request that final regulations provide guidance on how to determine when a method is a “reasonable method” in addressing the existence of multiple layers for a single asset.

6.5. We recommend that final regulations provide that the disparity offset method, described below, is a permissible and reasonable section 704(c) method to account for revaluation layers. ■
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