POINT TO REMEMBER

Is It Worthwhile to Realize Capital Gains to Finance the Tax for the Roth Conversion?

By William K.S. Wang*

My earlier article, Some Immediate and Long-Term Advantages of a Roth IRA Conversion, NewsQuarterly, Winter 2011, at 10, analyzed the general benefit of a Roth conversion assuming a constant flat ordinary income tax rate and assuming the taxpayer had the cash to pay the resulting ordinary income tax. It did not address whether the taxpayer would still benefit were she to realize capital gains to finance the ordinary income tax due.

In fact, even in that situation, the Roth conversion should be advantageous assuming the following: (1) a constant flat ordinary income tax rate; (2) a constant flat capital gains tax rate; (3) a zero basis on the asset that would be sold to finance the ordinary income tax for the Roth conversion; (4) possession of enough cash to pay the capital gains tax at conversion; and (5) an equal increase in the values of the assets held in either the Roth IRA or, alternatively, the traditional IRA and the accounts holding the tax amounts that would otherwise be paid. (The Roth conversion may or may not be beneficial in the event of an equal decrease in the values of the assets held in either the Roth IRA or the alternative accounts.)

The Appendices to this article contain several other illustrations, including one that assumes a $40 (rather than zero) basis on the $100 capital asset that would be sold to finance the tax for the conversion and examples that assume a lower capital gains rate at liquidation than at possible conversion.

I do not address borrowing to pay the income tax on the Roth conversion. Were the Roth IRA in stock mutual funds, the borrowing would increase risk.

Adaptation of Earlier Analysis and Terminology

For simplicity, as in my original article, I shall assume that the federal ordinary income tax rate will be a flat 50% forever and that there will be no state income or capital gains taxes. (I could also have assumed some other constant flat federal ordinary income tax rate. For example, with a constant flat 33 1/3% ordinary income tax rate, the two hypothetical accounts would be a $300 traditional IRA account and a $100 account I own outright.)

I start with two accounts holding the same stock mutual fund: (1) a $200 traditional IRA account with a zero basis; and (2) a $100 account I own outright. In effect, the Service has a half ownership in my traditional IRA $200 account. If I withdraw part or all of the money from the IRA, I must pay the Service half. The Service is like a 50% partner. Throughout this article, I refer to these accounts as, respectively, the traditional IRA account (or the first account) and the non-IRA account (or the second account).

* Professor, University of California, Hastings College of Law, San Francisco, CA. I greatly appreciate the valuable comments of Mr. C. Joseph Smith and Ms. Kwan Wang, Dean Malcolm Morris, and Professors Ellen Aprill, Bryan Choi, John Crawford, Herbert Lazenew, Jack Miller, and Stephen Schwarz.
Section Meeting Calendar

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FROM THE CHAIR

Investing in the Tax System

By Armando Gomez*

The Tax Section’s mission is “to serve our members and the public by providing education about taxes and tax systems, and by providing leadership to support the development of an equitable, efficient, and workable tax system.” Now, more than ever, the Tax Section needs its members to help with two very important needs for investment in the tax system.

Tax Assistance Public Service Endowment

First, the Tax Section recently established the Tax Assistance Public Service endowment fund (“TAPS”) to support tax-related public service programs approved by the Section’s Council. The initial expectation is that income from the TAPS fund will support the Christine A. Brunswick Public Service Fellowship program. The Council also may decide to use income from the fund to support other tax-related public service initiatives designed to broaden the reach of existing programs to even more underserved taxpayers than can be practically served today. With an initial target endowment of $5 million, the Council approved the transfer of $2.5 million to kick start the fundraising. With your support, we will build the remaining $2.5 million to reach our goal over the next five years.

The Brunswick Fellowship program was established in 2008 with a goal of building a network of public service minded lawyers to help provide a safety net for taxpayers most in need of help. Over the past six years, the Section has awarded two-year fellowships to 12 young lawyers. I have had the pleasure of spending time visiting with each of these lawyers and have truly been touched by the drive and dedication that they bring to assisting underserved taxpayers. These dedicated young lawyers have worked to provide representation from Portland, Maine, to Pasco, Washington, and numerous communities in between. Several fellows have focused on developing and advocating for policy changes to address the needs of low-income taxpayers.

The Section’s former executive director, Christine Brunswick, believed in the importance of investing in the tax system and inspired many members over the years to do more. Like the acorn that grows into a towering oak that provides shelter for many, with all of your support, the Fellowship program that bears Christine’s name will one day ensure that underserved taxpayers throughout the country will have qualified advocates when they are most in need of help. An interview with one of the Section’s newest fellows, Patrick Thomas, and details on how you can help us grow this program appear on the adjoining pages of this newsletter. I hope that each of you will join me in supporting the TAPS fund and helping to ensure a lasting legacy for Christine’s vision.

Funding for the IRS

Second, for many years the Tax Section, on behalf of the American Bar Association, has encouraged Congress to provide adequate funding to enable the Internal Revenue Service to effectively administer and enforce the tax laws. Unfortunately, not only has Congress failed to heed our calls in recent years to increase funding for the Service, in the omnibus appropriation package approved in December 2014, Congress significantly reduced the Service’s appropriation.

Without sufficient funding, the Service cannot effectively serve taxpayers and enforce the laws that Congress enacts. Whatever your views might be on the merits of those laws, the dedicated men and women who work for the Service are serving our nation by helping taxpayers understand the law, answering questions regarding how to qualify for credits or other incentives that Congress has enacted, and processing returns and tax refunds that help put money back into the economy each year. These public servants also give us comfort that the tax system is fairly applied, using the examination and enforcement tools to ensure that everyone meets their tax obligations. Unfortunately, the funding shortfall imposed on the Service by Congress will hamper their ability to fulfill their critical mission.

The Commissioner recently warned that a direct consequence of the funding reduction will be a reduction in taxpayer service during the upcoming filing season. Over time, the consequences are likely to be even more severe. Reducing funding for the Service will lead to a direct reduction in tax collections. Not only will this exacerbate the nation’s fiscal problems, but a greater concern is that it is likely to undermine confidence in our voluntary tax compliance system as honest and diligent taxpayers come to believe that other taxpayers are not paying their proper share.

I recognize that there are many in Congress who do not support some of the programs that the Service is required by law to administer. I also recognize that there are many in Congress who want to ensure that the Service’s enforcement activities are subjected to careful review and oversight. Those are fair questions that politicians

* Skadden, Arps, Slate, Meagher & Flom LLP, Washington, DC.

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At the Crossroads in America

By Francine J. Lipman*

James Dean, David Letterman, Raggedy Ann, and the gasoline pump were all born in Indiana. Recently, the state at the Crossroads of America has suffered poverty increases at a faster rate than in all but five other states. More than a million Hoosiers live in poverty and more than two million residents (including 45% of Indiana children) are officially “low income,” with household incomes that are less than 200% of the federal poverty level.

While jobs have been on the rise since the Great Recession, Indiana has the fifth-highest concentration of fast-food and janitorial workers in America. The Center for Economic and Policy Research notes that the majority of these workers are adults, of whom 85% have a minimum high school education—and more than a quarter are raising children. Not surprisingly, these families depend upon antipoverty relief delivered through the federal income tax system.

Fortunately, Patrick Thomas, a Tax Section Public Service Fellow at the Neighborhood Christian Legal Clinic, is in Indianapolis providing pro bono tax assistance.

In Patrick’s own words …

NQ What made you first apply for the Fellowship?

PT I’ve always been interested in serving the low-income and immigrant communities in central and southern Indiana. In law school, I began working with the Neighborhood Christian Legal Clinic—my current sponsor—in the summer after my first year. I worked on a number of immigration law issues, including helping victims of violent crimes obtain a stable immigration status in the United States.

My interest in tax arose after I started volunteering with the Indiana University’s Volunteer Income Tax Assistance (VITA) program during law school. It was there that I saw first-hand the federal government’s attempts to address systemic poverty through the tax code. Through my three years in VITA, I began to understand the value of refundable credits, such as the Earned Income Tax Credit, to low-income families.

When I first heard of the fellowship, I knew that Neighborhood Christian had an excellent Low-Income Taxpayer Clinic (LITC). I had been interested in getting involved with an LITC throughout my time with VITA, and this was a perfect opportunity. My familiarity with the organization combined with my experience serving low-income taxpayers in Bloomington made applying for the fellowship a natural choice.

NQ Tell us about the area your clinic serves.

PT The LITC at the Neighborhood Christian Legal Clinic serves our low-income neighbors throughout Indiana. Thanks to the growing reach of our Clinic as a whole, we now have a physical presence in Fort Wayne, Richmond, Kokomo, Madison, Gary, and other cities in the state. In Indianapolis, we see a large number of clients from our immigrant communities—including those from Mexico and Central America, and also our burgeoning refugee community, which includes clients from Burma, the Democratic Republic of the Congo, Syria, Iraq, and others.

The LITC is only part of the legal services offered at the Neighborhood Christian Legal Clinic. We also help immigrant clients obtain various forms of immigration status in the United States, negotiate with mortgage lenders to achieve affordable monthly payments, and assist our clients with myriad other legal issues, such as landlord/tenant disputes, bankruptcy, consumer debt, expungement, and family law, among others.

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

PT In my short time with the Clinic, I’ve been able to take on a number of tax controversy cases, which has allowed the Clinic to take on more tax controversies as a whole. Additionally, it’s freed up resources to implement systemic changes to our LITC that allow us to better serve our clients. For example, I’ve led our efforts to acquire and implement tax preparation and controversy software that reduces errors, keeps all of our attorneys on the same page, and further improves our case processing efficiency.

Further, my language abilities and cultural competencies have allowed me to better assist our English-as-a-Second-Language clients. Not only must they speak a foreign language in their everyday lives in the United States, they must, as a matter of law, negotiate complicated tax and other legal issues that are entirely unheard of in their home countries.

For example, the very concept of a tax return or a tax refund is completely unheard of in the Democratic Republic of the Congo. My clients, who were in a dispute with the Service, were asking me questions such as “Why are we supposed to get this money in the first place?” “Do we get this amount every year?” “Why do we have to file documents?”

Without getting too theoretical, I was able to explain the basic concept of tax

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withholding versus the reconciliation process on the tax return, along with the Earned Income Credit and how it offsets any taxes they might otherwise owe. They had previously gone to a tax preparer who had not explained any of the above, made up phony income to increase their EITC, and caused this controversy in the first place. Armed with this information, I hope that these clients, along with the other new immigrant clients I speak with, are able to make wiser choices about their tax preparer in the future.

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

**PT** Most of our clients come to us with a letter stating that the Service intends to levy on their wages, Social Security, or other income. At this point, they’ve already received letters—often poorly worded and confusing, as a recently published TIGTA report pointed out—that advise them of the tax debt, or of an audit. But frequently, it’s only at the point where the Service actually attempts to take the taxpayer’s property that these letters have any effect on many taxpayers; often long gone is the taxpayer’s opportunity to challenge the amount of the tax itself.

Thus, the greatest bulk of our efforts consists of collection matters, including placing clients into Currently Not Collectible (CNC) status and preparing Offers in Compromise (OICs). When our clients do not have the ability to pay their taxes in full—or even make a monthly payment towards them—without severely hampering their ability to provide for themselves or their family, CNC status offers a reprieve from the Service threatening levies on wages or assets, along with the constant letters. Once a client is in CNC status, we’ll then look closely at the case to determine whether to offer the Service an amount of money to settle the client’s aggregate tax debts permanently. Sometimes the relief here can be substantial; for example, I recently successfully negotiated a $1 offer for a client with a liability over $110,000, accumulated over the course of 13 years.

I have also prepared past-due tax returns (these are required as a condition of the forms of relief listed above), requested innocent spouse relief, represented taxpayers in Service examinations, counseled pro se litigants in Tax Court, and negotiated settlements for some of them.

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

**PT** There are two parts of my practice that I enjoy the most: averting a crisis and educating a client for future success. As noted above, the vast majority of our clients come in because they are facing a crisis: their income or assets are about to be taken, often leaving them in dire financial straits. All of our clients are very grateful when we’re able to negotiate a low payment plan or place their tax accounts into CNC status.

But this only stops the bleeding. My favorite part of the job is creating a plan for the client to resolve their tax liabilities and place them on the path to future tax compliance. Often this involves multiple steps, balancing various risks, and many meetings with the client, but the increasing intricacy makes it all the more interesting for me—and rewarding when it works out for the client.

**NQ** What has been your biggest challenge in the position?

**PT** Even where I’m able to negotiate a successful settlement with the Service, the Indiana Department of Revenue is often much more aggressive in their enforcement of delinquent tax debts, and has very few avenues for relief—even for taxpayers who are already in economic hardship, without paying a monthly tax bill. Sometimes my successes are thus a pyrrhic victory. It is at once frustrating for me and causes extreme hardship for low-income Hoosier taxpayers.

**NQ** You have attended several Tax Section meetings. How have they helped you in your work?

**PT** These meetings have been extraordinarily helpful. Not only do I get the opportunity to network with the brightest minds in taxation, the various panels and forums allow me to learn about more effective ways to serve my clients. For example, at the May 2014 meeting, the Individual and Family Committee held a panel on recent developments in Innocent Spouse relief. I had just done an intake for such a case, and was able to immediately apply the panel’s expertise to assist my client.

**NQ** Do you have any advice for lawyers or law students interested in public service or pro bono work?

**PT** Get your hands dirty, early and often. Seek out volunteer opportunities through your law school or your firm’s pro bono coordinator. It’s incredibly important for multiple reasons. First, if law students or young lawyers are interested in pro bono work or careers in public service, it’s important to build your network with lawyers performing the work on a day-to-day basis. We will never turn down an opportunity for free help! Demonstrating
this interest is also likely to lead to future opportunities. Second, for those interested in pursuing public service as a profession, it’s important to get a handle on the type of work you’d be doing in any given setting. Public service work varies greatly and it’s critical to tease out what type of work you’d like to do—and especially what you don’t want to do. Finally, it’s a chance to build up your skill set in a particular area. While you don’t need a full background in all facets of the work of a public interest lawyer, having experience in a few areas will be particularly helpful—both to getting the job and performing it.

After the Fellowship, do you currently plan to stay at the Clinic? If not, will the position you have created exist after you leave?

I don’t currently know what the future holds. I will certainly continue my relationship with the Neighborhood Christian Legal Clinic in whatever capacity I’m able that allows me to serve our neighbors in central Indiana. Whether that’s in a volunteer capacity or in my current position will depend—like most decisions in the nonprofit world—on the availability of adequate funding. I’m definitely planning to continue working with tax controversies and look forward to exploring the wide range of opportunities that exist in this field.

Since 2009, the Section has funded two Christine A. Brunswick Public Service Fellows each year, including these amazing young lawyers. Details about the Fellowship are available at http://www.americanbar.org/groups/taxation/awards/psfellowship.html.

2009-2011
Laura Newland (AARP’s Legal Counsel for the Elderly, Washington, DC)
Vijay Raghavan (Prairie State Legal Services, Rockford, IL)

2010-2012
Douglas Smith (Community Action Program of Lancaster County, PA)
Katie Tolliver Jones (Legal Aid Society of Middle Tennessee and the Cumberlands, Nashville, TN)

2011-2013
Sean Norton (Pine Tree Legal Assistance, Inc., Portland, ME)
Anna Tavis (South Brooklyn Legal Services/Immigrant Workers’ Tax Advocacy Project, New York, NY)

2012-2014
Ana Cecilia Lopez (University of Washington, Low-Income Taxpayer Clinic, Pasco, WA)
Jane Zhao (Center for Economic Progress, Chicago, IL)

2013-2015
Susanna Birdsong (National Women’s Law Center, Washington, DC)
Susanna Ratner (SeniorLAW Center, Philadelphia, PA)

2014-2016
Patrick Thomas (Neighborhood Christian Legal Clinic, Indianapolis, IN)
Lany Villalobos (Philadelphia Legal Assistance, Philadelphia, PA)

should debate if they so choose. But they should exercise their legislative prerogatives in a responsible manner that does not unfairly punish the dedicated employees of the Service or the taxpayers they serve. As representatives and advisors to taxpayers around the country, members of the Tax Section will see the consequences first-hand when our clients cannot get answers to their questions, or face even longer wait times to receive refunds, resolve tax audits, or otherwise conclude their interactions with the Service.

Members of the Tax Section can weigh in to support our friends and colleagues at the Service. Please consider writing or calling your representatives in Congress to ask them to restore the funding that was recently cut. Please remind them that every dollar spent on the Service helps the government collect nearly $300. That’s the type of return on investment that even the best money managers can only dream of achieving. And given the importance of a well-functioning tax system to provide for our government, it’s an investment worth making.
ABA Section of Taxation

Tax Assistance Public Service Endowment Fund

Through the newly created Tax Assistance Public Service (TAPS) endowment fund, the American Bar Association Section of Taxation will provide stable, long-term funding for its tax-related public service programs for underserved taxpayers. The initial expectation is that, once the $5 million endowment goal is reached, income from the TAPS fund will be dedicated to support the Christine A. Brunswick Public Service Fellowship program. Young tax attorneys funded by this two-year fellowship work to provide tax-related legal assistance to the underserved. When applying for these highly competitive fellowships, the applicants must secure a potential position with a nonprofit organization that will sponsor and supervise their work during the term of their fellowship.

Other programs and services that might be supported by the TAPS Endowment include:

- Low-Income Taxpayer Clinic (LITC) Assistance: The Section of Taxation publishes a manual to help LITCs understand how to effectively represent low-income taxpayers, and provides scholarships to clinicians to attend Section meetings where they can obtain continuing legal education and training to take back to their clinics.
- Volunteer Income Tax Assistance (VITA): Across the nation, volunteers help prepare basic income tax returns for low-income taxpayers or those with special needs, such as the elderly, non-English speaking persons, and persons with disabilities.
- Adopt-a-Base: Volunteers go through a training and certification process, and then train military personnel to prepare returns in their base’s VITA program. Volunteers can also be available to provide representation to members of the military who encounter tax controversies with the IRS or state tax authorities, or to provide tax advice on issues specific to their military service.
- Calendar Calls: Volunteers provide national coverage at Tax Court calendar calls and are available to consult with unrepresented taxpayers to advise them on court procedure, assist with settlement discussions, and in some cases, to take on their representation before the court.
- Tax Assistance to Disaster Victims: The Section of Taxation has provided pro bono tax assistance to victims of disasters, including in the aftermath of the 9/11 terrorist attacks and Hurricane Katrina. The Section of Taxation helped put in place a memorandum of understanding with the IRS and FEMA to establish a network of volunteers who are able to provide pro bono tax assistance to displaced Americans in times of need.
- Education and Research: The Section of Taxation has funded numerous educational programs and studies addressing important tax policy issues, including the needs of underserved taxpayers.

What You Can Do to Help

In addition to volunteering your time, we need your financial support. Please give generously to the TAPS endowment fund. Donations of $5000 or more can be spread over up to five years. The TAPS endowment fund will accept contributions of cash or appreciated securities, and also has flexibility to accept contributions through various planned giving options.

http://ambar.org/taxtaps
FOCUS ON THE COURTS

Standing Issues in Tax Litigation

By Steve R. Johnson*

Issues as to standing have appeared in tax cases for generations, but the frequency of their appearance has increased markedly in recent years. In 2014 alone, nearly a dozen opinions in high-profile tax cases plumbed the depths of standing doctrine.

This article summarizes the principal rules governing standing. Then it illustrates standing issues in tax litigation, in both traditional Code and Administrative Procedure Act (APA) contexts.

Standing in Brief


Traditionally, standing is thought to have both constitutional and prudential dimensions. The constitutional dimension emanates from Article III, Section 2, Clause 1, which limits the scope of the federal judicial power to “Cases [or] Controversies.” The “irreducible constitutional minimum of standing” entails three aspects. The plaintiff must show that (1) she suffered a legally cognizable injury, (2) the injury is fairly traceable to the conduct complained of, and (3) a favorable decision would likely redress the injury. Lujan v. Defenders of Wildlife, 504 U.S. 555, 560–61 (1992).

Prudential standing embodies “judicially self-imposed limits on the exercise of federal jurisdiction.” Allen v. Wright, 468 U.S. 737, 751 (1984). Although “not exhaustively defined,” it was said to reflect at least three broad principles: “the general prohibition on a litigant’s raising another person’s legal rights, the rule barring adjudication of generalized grievances more appropriately addressed in the representative branches, and the requirement that a plaintiff’s complaint fall within the zone of interest protected by the law invoked.” Elk Grove Unified School Dist. v. Newdow, 542 U.S. 1, 12 (2004) (quoting id.).

However, federal courts generally are obligated to hear and decide cases within their jurisdiction. E.g., Sprint Commun., Inc. v. Jacobs, 134 S. Ct. 584, 591 (2013). Prudential standing (and other doctrines like ripeness and mootness) are “in some tension with” that obligation. Lexmark Int’l, Inc. v. Static Control Components, Inc., 134 S. Ct. 1377, 1386 (2014)(seeming to convert “zone of interest” analysis from part of standing to part of statutory interpretation). This “has placed the continuing vitality of the prudential aspects of standing … in doubt.” Kentucky v. United States ex rel. Hagel, 759 F.3d 588, 596 n.3 (6th Cir. 2014).


Standing in Traditional Code Cases

“Traditional” cases involve one or a few taxpayers in forms of action prescribed by the Code, including deficiency actions, refund suits, and eligibility suits under provisions such as sections 7428 and 7476 to 7479. In cases such as these, indeed in most cases, a plaintiff’s “standing to seek review of administrative action is self-evident.” Sierra Club v. EPA, 292 F.3d 895, 899–900 (D.C. Cir. 2002). For discussion of “self-evident standing,” see American Ins. Ass’n v. U.S. Dep’t of HUD, 2014 WL 5802283, at *6 (D.D.C. Nov. 7, 2014).

 Nonetheless, standing issues can arise even in traditional tax cases. For example, the Service sought to use evidence obtained from a search as to Kersting to support its adjustment against the Dixons. The Dixons alleged that the Service had obtained the evidence from Kersting illegally. The Tax Court, noting that one cannot assert the rights of others, held that the Dixons lacked standing to assert Kersting’s Fourth Amendment rights. Dixon v. Commissioner, 90 T.C. 237 (1988).

However, standing often has been invoked in questionable situations. For instance, the courts have relied on lack of standing to hold that a taxpayer may not (1) sue in his individual capacity when the Service issued a notice to him as possessor of unclaimed cash under section 6867, Matut v. Commissioner, 84 T.C. 803, 808 n.7 (1985); (2) assert that the U.S. is violating treaties and committing war crimes as a basis for not paying her income taxes, e.g., Scheide v. Commissioner, 65 T.C. 455 (1975); (3) defend claimed charitable contribution deductions by arguing that section 170 is unconstitutional, Kessler v. Commissioner, 87 T.C. 1285, 1293 (1986); or (4) as the nonrequesting spouse, argue about the amount of tax owed (pre-relief) by the spouse claiming relief under section 6015.

* University Professor of Law, Florida State University College of Law, Tallahassee, FL.
Standing in APA Cases

Although traditional Code forms of action far predominate, increasing numbers of litigants base their suits against Treasury or the Service on the APA. Under the APA, redress is available to anyone “suffering legal wrong because of agency action, or adversely affected or aggrieved by agency action.” 5 U.S.C. § 702. The reviewing court may, among other remedies, compel agency action wrongly withheld or set aside agency action that is arbitrary and capricious, in excess of statutory authority, or procedurally improper. 5 U.S.C. § 706 (1) & (2).

An APA challenge may be brought via “any applicable form of legal action” unless a special review scheme is mandated. 5 U.S.C. § 703. Thus, if a deficiency, refund, or other Code-based form of action is available, it must be used instead of suit under the APA. Plaintiffs also must overcome other hurdles in order to proceed under the APA. In addition to standing, these hurdles include such issues as ripeness, exhaustion of remedies, and the Anti-Injunction Act, I.R.C. § 7421.

APA tax suits often pit powerful adversaries against each other: the government defending the regulation or other position against attacks by well-organized and well-funded industrial or ideological interests, often fronted by one or several individual plaintiffs. The government typically argues that the plaintiffs lack standing to seek some or all of the relief sought. Some recent examples are noted below.

In Florida Bankers Ass’n v. U.S. Dept of Treasury, 2014 WL 114519 (D.D.C. Jan. 13, 2014), two bankers associations challenged Treasury regulations requiring reporting of information on U.S. accounts of foreign depositors, which information the Service would share with the revenue authorities of depositors’ home countries. The standing issue involved the doctrine of organizational or representational standing, under which an organization may litigate on behalf of its members under certain conditions. Noting that banks in the associations were directly affected by the regulations, the court found that standing was self-evident, without the need for detailed affidavits.

In another recent representational standing case, to fill the gap felt by invalidation of its mandatory program in Loving v. IRS, 742 F. 3d 1013 (D.C. Cir. 2014), the Service launched an effort to encourage unenrolled return preparers to “voluntarily” enhance their skills. The AICPA sued to invalidate this effort. The court granted the government’s motion to dismiss. One of the elements for representative standing is that at least one of the organization’s members would have standing to sue in its own right. This element was not met. The AICPA has no members who are unenrolled preparers, and the AICPA’s attempts to connect their members to the voluntary program were too speculative, conclusory, or unrelated. American Inst. of Certified Pub. Accountants v. IRS, 2014 WL 5585334 (D.D.C. Oct. 27, 2014).

Atheist organizations and associated individuals brought suits seeking invalidation of the section 107 parsonage allowance. In 2013, the Western District of Wisconsin found that the plaintiffs had standing to challenge section 107(2) but not section 107(1). On appeal, the Seventh Circuit vacated the decision on the ground that the plaintiffs lacked standing. Freedom from Religion Found., Inc. v. Lew, 2014 WL 5861632 (7th Cir. Nov. 13, 2014), rev’d 983 F. Supp. 2d 1051 (W.D. Wis. 2013). Another 2014 decision also rejected, on standing grounds, a challenge to the parsonage allowance. American Atheists, Inc. v. Shulman, 2014 WL 2047911 (E.D. Ky. May 19, 2014).

The section 107 cases are interesting in at least two respects. First, in general, one does not have standing simply as a taxpayer; this interest is insufficiently particularized. There is a narrow exception under Flast v. Cohen, 392 U.S. 83 (1968). The cases explored and rejected the applicability of that exception.

Second, the injury claimed by the atheists was that they were barred from receiving the benefit that church officiants were getting. But the atheists never applied to the Service to receive those benefits. The opinions differed sharply as to how likely the Service would have been to approve the applications had they been made. Whether the point is formalistic or not, the atheists’ failure to apply counted heavily against them. The causation aspect of constitutional standing is not met when the harm results from the plaintiffs’ own voluntary action or inaction.

Despite the upholding of the shared responsibility payment in National Fed. of Independent Bus. v. Sebelius, 132 S. Ct. 2566 (2012), challenges to the Affordable Care Act (ACA) remain plentiful—and produce many standing issues. Liberty University and others challenged the validity of the ACA’s employer mandate. The government moved to dismiss for lack of standing on the ground that the plaintiffs face no actual or imminent injury. The motion failed. Liberty had the burden of proving standing, but the required showing may change as the case progresses. To defeat a motion to dismiss, Liberty “need not prove that the employer mandate will increase its costs of providing health coverage; it need only plausibly allege that it will.” Liberty Univ., Inc. v. Lew, 733 F.3d 72, 90 (4th Cir. 2013)(emphasis in original), cert. denied, 134 S. Ct. 683 (2013).
Several cases have challenged the validity of regulation section 1.36B-2(a)(1), which extends the ACA’s premium assistance credit to persons enrolled in federal exchanges set up in states which declined to establish medical insurance exchanges. The courts typically have held that the governmental and private plaintiffs have standing. Even though part of their motivation is ideological, the plaintiffs face additional expenses under the ACA, which suffices to establish standing. E.g., Halbig v. Burwell, 758 F.3d 390 (D.C. Cir. 2014); see also King v. Burwell, 759 F.3d 358 (4th Cir. 2014); Oklahoma ex rel. Pruitt v. Burwell, 2014 WL 4854543 (E.D. Okla. Sept. 30, 2014).

Conclusion

Standing issues are not the “meat and potatoes” of federal tax litigation. However, they are of growing importance. The able tax attorney should have at least working knowledge of the intricacies of standing doctrine.

When the Bough Breaks: The U.S. Tax Court’s Branch Difficulties

By Leandra Lederman*

A 2014 opinion issued by the Court of Appeals for the D.C. Circuit brought to the fore a fundamental unanswered question: in which branch of government is the U.S. Tax Court located? In 1969, Congress transformed the former agency into a “court of record” under “article I of the Constitution.” I.R.C. § 7441. However, Congress did not specify which branch would house the court.

In Kuretski v. Commissioner, 755 F.3d 929 (D.C. Cir. 2014), the case that renewed interest in this question, the taxpayers argued that the President’s right to remove a Tax Court judge raises a separation of powers problem because the Tax Court is located in the judicial branch or, alternatively, in the legislative branch, id. at 932. The D.C. Circuit rejected the taxpayers’ assertions, finding instead that the Tax Court “exercises its authority as part of the Executive Branch.” Id. at 943.

Was the D.C. Circuit correct? The law in this area is so uncertain that, barring Supreme Court review, it is hard to know. A 1969 Senate Report states that Congress intended to cease having “one executive agency . . . sitting in judgment on the determinations of another executive agency” and that it was therefore making “the Tax Court an Article I Court rather than an executive agency.” S. Rep. No. 91-552, at 303 (1969). This language could mean that Congress intended to move the Tax Court out of the executive branch. However, another possible reading is that Congress intended only to transform the Tax Court into a court—so it would no longer be an agency overseeing another agency. The Supreme Court in Freytag v. Commissioner, 501 U.S. 868, 890 (1991), quoted the Senate Report language in the context of an Appointments Clause challenge to the selection of the Tax Court’s Special Trial Judges. Although the four concurring justices argued that “the Tax Court is a free-standing, self-contained entity in the Executive Branch,” id. at 915 (Scalia, J., concurring), the five-justice majority reached the narrower holding that “[t]he Tax Court is not a ‘Department’” within the executive branch, id. at 888. It found that the Tax Court is a “Court of Law” within the meaning of the Appointments Clause and that it exercises the “judicial power of the United States,” id. at 889–90, but it did not indicate in which branch the court is located.

Perhaps, as the Freytag concurrence argued, Congress never removed the Tax Court from the executive branch. See Robin J. Arzt, Recommendations for a New Independent Adjudication Agency To Make the Final Administrative Adjudications of Social Security Act Benefits Claims, 23 J. Nat’l Ass’n Admin. L. Judges 267, 330–31 (2003) (asserting that “[t]he U.S. Tax Court was . . . an Executive Branch Article II court until it was converted into an Article I Executive Branch court in 1969”). The Tax Reform Act of 1969 states in an off-Code provision that “[t]he United States Tax Court established under the amendment . . . is a continuation of the Tax Court of the United States as it existed prior to the date of the enactment of this Act . . . .” Pub. L. No. 91-172, § 961, 83 Stat. 487, 735 (1969). A court decision just before Freytag relied on that statement to hold that the Tax Court was “a department associated with the Executive Branch.” Samuels, Kramer & Co. v. Commissioner, 930 F.2d 975, 994 (2d Cir. 1991). Additionally, a nontax decision interpreted Freytag to mean that the Tax Court is a court of law “despite being part of the Executive Branch.” S.C. State Ports Auth. v. FMC, 243 F.3d 165, 171 (4th Cir. 2001), aff’d, 535 U.S. 743 (2002).

If Congress did in fact remove the Tax Court from the executive branch in 1969, where did Congress place the court? Some have stated that the Tax Court is located in the judicial branch. See, e.g., Harpole v. United States, No. A00-176CV (HRH), 2000 U.S. Dist. LEXIS 17697, at *8 (D. Alaska Nov. 3, 2000) (“The Tax Court is . . . independent of the executive and legislative branches . . . and is considered part of the judicial branch of the government.”); J. Martin Burke & Michael K. Friel, Understanding Federal Income Taxation § 1.02 (4th ed. 2013) (“The 1969 Act renamed the court the

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‘United States Tax Court’ and gave it ‘constitutional status’ under Article 1, Section 8, Clause 9 of the Constitution, so that it is now part of the judicial branch.”).

Can the judicial branch encompass courts that lack Article III protections? Miller v. French, 530 U.S. 327, 341 (2000), observed, “The powers of the Judicial Branch are set forth in Article III, § 1, which [contemplates one Supreme Court and inferior courts] . . . and provides that these federal courts shall be staffed by judges who hold office during good behavior . . . .” Moreover, the Federal Judicial Center’s website states, “Some federal courts and adjudicative bodies are not part of the judicial branch. These courts are served by judges who do not have the Article III protections.” That website lists the Tax Court among the adjudicative bodies housed outside the judicial branch. See Fed. Judicial Ctr, Federal Courts Outside the Judicial Branch, http://www.fjc.gov/history/home.nsf/page/courts_special_fcotj.html.


Could the OMB be correct that the Tax Court is in the legislative branch? The 1969 law “establish[ed] the Tax Court as a court under Article I of the constitution, dealing with the Legislative Branch.” S. Rep. No. 91-552, at 304 (1969). Perhaps this law located the Tax Court in that branch. See, e.g., Ostheimer v. Chumbley, 498 F. Supp. 890, 892 (D. Mont. 1980) (“[T]he Tax Court . . . became a part of the legislative branch of government in 1969.”), aff’d without op., 746 F.2d 1487 (9th Cir. 1984); Theodore Tannenwald, Jr., The United States Tax Court: Yesterday, Today, and Tomorrow, 15 Am. J. Tax Pol’y 1 (1998) (“The Tax Reform Act of 1969 . . . made the Court a legislative court, thus technically part of the Legislative Branch of Government, although clearly recognized as a judicial body.”). Of course, it is possible to interpret the Senate Report’s statement as referring only to the power used to create the court, not the court’s location.

If none of the conflicting statements above is completely satisfying, could the Tax Court be located outside the three branches? There is a debate over whether independent agencies comprise an unenumerated “fourth branch.” See, e.g., Richard J. Pierce, Jr., The Role of Constitutional and Political Theory in Administrative Law, 64 Tex. L. Rev. 469, 510 (1985) (“Humphrey’s Executor simultaneously spawned the concept of an ‘independent agency,’ which Congress values so highly, and the concept of a headless fourth branch of government, which jurists and scholars frequently decry.”); Peter L. Strauss, The Place of Agencies in Government: Separation of Powers and the Fourth Branch, 84 Colum. L. Rev. 573, 578 (1984) (“Experience has accustomed lawyers and judges to accepting the independent regulatory commissions . . . as a ‘headless fourth branch’ of government.”). The Tax Court is no longer an independent agency but perhaps it nonetheless lies in that lacuna. Cf. Strauss, supra, at 574 (mentioning the issue of special adjudicative tribunals, including Article I courts).

Ultimately, all of this analysis—and the federal government’s inconsistent categorization of the court—highlight the current lack of a concrete answer to the branch question. Meanwhile, the Tax Court’s unclear position makes it unusually unaccountable and insular. See Leandra Lederman, Tax Appeal: A Proposal to Make the U.S. Tax Court More Judicial, 85 Wash. U. L. Rev. 1195, 1213 (2008). The Tax Court should be unambiguously located somewhere, to resolve these issues and avoid further constitutional challenges like the one in Kuretski. ■
INTERVIEW REVISITED

Senator Bob Packwood

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

Bob Packwood represented the state of Oregon in the United States Senate from 1969 to 1995, and he was Chairman of the Senate Finance Committee during the passage of the Tax Reform Act of 1986. At the time of the interview, he was a legislative consultant in Washington, D.C.

Q Senator Moynihan, in his comments on the IRS Restructuring bill, recalled that he was part of the “core group” that met daily in your office to plan the passage of the Tax Reform Act of 1986, which he described as “broadening the base and lowering the rates.” With the benefit of hindsight, what is your view of the 1986 Act’s legacy?

A The 1986 Act set the standard that many tax reformers say they want to return to, in one form or another, whether it’s Bob Novak, Jack Kemp or just about anyone else. They frequently say that Congress should focus on closing loopholes, broadening the base and thereby lowering the rates, which is exactly what we did in 1986. I think most people still agree that the 1986 Act was a very good step and we ought to be aiming in that direction again. The unfortunate fact, however, is that we are not following the direction and philosophy of the 1986 Act; we are going in the opposite direction.

Q Was it suspected from the outset that the 28% individual rate, without a capital gains preference, would not hold?

A There were some critics in 1986 who complained that we would get rid of their deductions and then raise the rates, which is what eventually happened. At the time, I said that I could not guarantee that the rates would not be increased in later years because the acts of any one Congress cannot bind a future Congress. I also believe that we are going to see still more deductions and credits added to the tax code, contrary to the basic philosophy of the ’86 Act. When the marginal rates are high, as they are now, legislators like to encourage particular behavior through targeted tax breaks, whether it be a Roth IRA, an education credit or whatever else. And, with each new tax break, the code becomes a tad more complex.

As I said, there was some criticism that the rates would go up again, but the critics were mainly those who did not like what we were doing, particularly with respect to the alternative minimum tax and the elimination of passive losses, which hit real estate hard. I suppose Congress is somewhat at fault since we essentially gave real estate all those tax breaks in 1981. After the 1981 Act, many people were clearly investing for tax reasons and not business reasons. When we came to that realization in 1986, we took away many of the breaks that had been enacted in 1981. So, the criticism in 1986 was primarily that real estate interests didn’t like us undoing what they had come to rely upon.

Congress doesn’t normally do that, but that is exactly what we did.

If there was a turning point in the 1986 Act, it happened the day that Pat Moynihan came in and asked me if I had seen an advertisement in a major newspaper which stated in big letters “Guaranteed Losses.” I believe that it related to investments in llamas, recording contracts or some other tax shelter scheme. Pat showed me the ad and asked, “What have we come to? We have a tax code that encourages people to buy guaranteed losses!” With, in essence, no real minimum tax, the ability to deduct passive losses and a capital gains preference, you quickly understood how someone could effectively reduce their taxes to zero, or very near zero. It wasn’t the capital gains preference by itself, of course. It was the combination of a capital gains preference, loose AMT provisions and passive losses that allowed people to escape taxation.

Q There are many opinions as to which Tax Act produced the most positive effects on the economy or, indeed, whether it is possible to quantify the economic impact of any tax legislation. Is there one particular Tax Act that you believe produced the most positive effects on the economy?
Fundamentally, I believe that the less taxes distort individual investment decisions, the better it is for the economy. In that regard, Reagan’s ‘81 tax cuts as proposed were, by and large, not very distortive because they didn’t tend to favor one sector. Taxes were simply cut across the board for everyone.

You have some who say that the 1981 Act led to a boom in the economy and others who say that all we did was increase the deficit. But, clearly, the 1981 and 1986 acts are the two tax acts that would stand out if you tried to prove, and I’m not sure whether you could prove it to a jury of 12 people, that tax cuts spur the economy.

On the other hand, you wouldn’t find very many people, particularly economists, tax lawyers, or academics, who would support the concept that we ought to use the tax code for all kinds of incentives. I believe that a tax code with fewer deductions, which we tried to achieve in the 1986 Act, is more efficient from an economic standpoint.

In that sense, the 1981 Act was different from the 1986 Act. In the 1981 Act, Congress, in addition to cutting taxes, added a whole list of tax preferences to the code, many of which were specifically targeted to real estate, such as accelerated depreciation. That caused money to be invested in real estate that probably wouldn’t otherwise have been invested. I can remember speaking to the national hotel association on this very subject in 1988 or thereabouts. I was speaking after the executive vice president of their association and I remember his words on the 1986 Act’s impact on real estate. I’m paraphrasing, but this is very close. He said, “The hotel business used to be a wonderful business, people would invest in it for tax reasons. Now, they won’t invest unless they think they can make money.” At the time, I thought to myself, “Yes! That’s exactly what we had in mind.”

There has been some talk of the capital gains rate being reduced. Do you foresee a further reduction in the rate?

It is interesting how the possibility of a further capital gains rate reduction could be helped by the increasing projections of large budget surpluses. Each time I see the Congressional Budget Office (CBO) projections of the surplus, I think to myself that it can’t possibly get any bigger. But, each new projection is bigger than the last. CBO recently estimated that the surplus will reach $1.6 trillion over the next ten years. Only seven months ago it was estimated at $600 billion. It has gone up $1 trillion dollars in just seven months, even though CBO is not assuming immense growth in the economy. The President warned Republicans during his State of the Union address against doing anything with the $600 billion surplus (before the recent upward revisions) without first taking care of Social Security. Of course, the Republicans are frightened to death of Social Security because they have been beaten over the head politically with it so often in the past. But, now that we have a $1.6 trillion surplus, the Republicans can say to the President, “Look, you wanted $600 billion for Social Security. Here it is. Now we have a trillion for tax cuts.”

It’s all somewhat ephemeral, but you’ve got to base the budget on some projections and these are the current projections. So, given the current outlook, I think the House may try a tax cut. If I were guessing, I would bet that two of the components would include a phase-out of the estate tax and some fixing of the marriage penalty. A phase-out of the estate tax would likely be a reduction of 5% each year under the so-called Dunn-Tanner bill, until it is completely phased out. Although I believe a complete phase-out is the likely scenario, I can picture that when it got as low as the capital gains tax rate there would be an argument made to freeze the estate tax at the capital gains rate.

Otherwise, the argument would be that a zero estate tax rate versus a 15-20% capital gains rate would be an incentive to hold all of your assets until you die and pass them on with no tax rather than selling assets while alive and paying a capital gains tax. To that argument, I would respond that I think the 50-year-old business person, if he or she could negotiate a good deal and the capital gains tax were 15 or 20%, would go ahead and sell anyway. Also, if you have no estate tax at all, so Tommy and Sally get mom and dad’s estate with no estate tax being paid and little or no capital gains taxes paid during the parents’ lives, you can bet there’s going to be a debate about the tax basis that the kids take in the inherited assets. That would be, frankly, a happy debate to have if we ever get to that stage.

A reduction in the capital gains rate from 20% to 15% is also a real possibility, but that just depends on how much money is available. Even if there is a rate cut, I don’t anticipate the holding period being reduced to six months. I think the House can pass a capital gains rate cut in addition to the other items I mentioned, but the House has a slightly different situation than the Senate.

The House can pass virtually any bill, including any tax bill, with a simple majority vote. The strict budget rules, the so-called “pay-go” (pay as you go) rules, really only apply in the Senate. The Rules Committee in the House sets the rules for debate on each bill and so, as a practical matter, the only key vote before the entire House is on the “rule” for debate when the bill reaches the House floor. The pay-go rule in the Senate was put in during the 1990 budget debate and it was insisted upon by President Bush and Senator Domenici in exchange for the tax increase. The pay-go rule basically provides that you cannot finance tax cuts by increasing the deficit, unless you can find 60 Senators to vote in favor of it, which can be very difficult. Of course, everybody was thinking about deficits at the time. The problem is that
the same wording applies to the surplus. So, in effect, you cannot finance tax cuts by using the surplus unless you can find 60 votes.

If we're talking about tax cuts this year, which would have to occur in September, my hunch is that the Republicans might pass a tax cut in the House even if it can't pass it in the Senate just to make the Democrats vote on it. But, I think the more interesting question is what will happen if we get to January without a big tax cut passed this year and CBO is still estimating a surplus of $1.6 trillion or maybe even $2 trillion, who knows. At that point, I believe the budget pay-go rules will be changed or, more likely, temporarily suspended for the next Congress. The pressure will be tremendous growth in stock ownership during the recent surge in the stock market made such a change any more likely? I'm not certain of the answer to your question for the following reason. I don’t know how many people are buying stocks for growth rather than dividends, in which case they don’t care if there is a tax on dividends because they don’t assume that they will be receiving dividends anyway. Their focus is solely on the capital gains rate.

However, I strongly believe the day will come when we will end the double taxation of corporations' earnings. But, whether it will come because of the tremendous growth in stock ownership or whether it will come in the context of a Nunn-Domenici type of bill, I just don’t know. I certainly give Nunn-Domenici a great deal of credit for the effort they put into crafting their proposal. They tried hard, but it was very complicated by the time they finished and it also depended on a high marginal rate. Corporate integration will occur, but it will not be easy.

How would you compare/contrast the period leading up to the Tax Reform Act of 1986 with the current movement to replace the income tax with a “flat” tax, a sales tax or any of the other consumption-based taxes? Is it possible to generate the same kind of bipartisan support around one of the current reform proposals that was so critical to the passage of the 1986 Act? Times were different in 1986 for two reasons. First, in 1986 we were getting beaten up academically and editorially with the unfairness, the complexity and the loopholes in the tax code. We were almost desperate to prove that we could do something good legislatively. There isn’t so much of that criticism at the moment, but maybe the 1986 Act is partially responsible for that. Secondly, the ’86 Act was reasonably equal in its treatment of all tax brackets. It avoided shifting the burden from one bracket to another. We cut the top rates and eliminated several deductions, but most of the deductions that we were getting rid of were those used by the upper income brackets anyway. So, the income distribution tables that we had the Joint Tax Committee preparing looked fairly good.

I think we will move to a consumption tax one day. A pure flat tax would have a rate of about 19%, but only if absolutely everything is counted as income, including such things as municipal bond income and fringe benefits. At the same time, deductions would have to be eliminated, including popular items like the deductions for charitable contributions, state and local property taxes, and home mortgage interest. A flat tax could be done at about 19% on that basis.

The primary argument against a consumption tax is that it will be regressive. A family with an income of up to $30,000 will likely be exempted, so they don’t pose a problem. The problem comes in the range of $30,000 to $120,000. If families under $30,000 are out and if everybody above $120,000 is going to pay 19%, which really amounts to a tax cut for that group, then where does the revenue come from if it’s going to be revenue neutral? The revenue shortfall would have to be made up from the $30,000 to $120,000 income range.

Having said that, I think tax reform could be done using a three-tier flat tax with about the same progressivity as under current law, but lower rates. Most of the deductions that you get rid of are not low-income deductions and they are only marginally middle-income deductions. When you look at the number of filers who file Form 1040 or Form 1040EZ and don’t take any deductions or very few, the process begins to resemble ’86 all over again. You are getting rid of deductions that upper income people utilize and you are lowering the rates.
Q: You mentioned the criticism of loopholes in the tax code as being one of the motivating factors that led to a readiness to do something in 1986. Bashing the IRS has become popular sport in recent years. Do you see the current attacks on the IRS as an analogy to the loophole issue, potentially leading to fundamental reform of the income tax code in addition to the IRS Restructuring bill that was recently enacted?

A: The recent criticism of the IRS isn't strong enough by itself and the passion that we saw in '86 just isn't there. In addition, you aren’t seeing the same level of editorials and academic articles. Leading up to the '86 Act, we had already gone through Treasury I and Treasury II, which were good studies. There were also innumerable academic symposiums on the subject of tax reform and it was a frequent topic on the Sunday morning talk shows. A lot of work was also done by Bill Bradley and Dick Gephardt and their Fair Tax Plan. In fact, Senator Bradley was really the godfather of the '86 Act. All of this activity laid the necessary groundwork for the '86 Act.

In contrast, there have been only a handful of editorials about IRS abuses, and you don’t have mass intellectual opposition to the IRS. I think that is the difference. I can understand how the frustration with IRS develops in some circumstances, however. A tax practitioner in Portland explained it to me this way. He said, “The IRS is not bad. You have to realize that the average IRS agent in La Grande, Oregon is probably making $38,000 and doesn’t know the tax law too well. And, he certainly doesn’t know it as well as a Portland tax specialist making a half-million dollars a year. An issue comes up with a taxpayer in La Grande and the poor taxpayer doesn’t know the law, but he senses something is unfair. He hires the tax lawyer from Portland and it’s really sort of embarrassing to the agent because of the agent’s lack of knowledge. It’s not really the agent’s fault. You’ve got these agents in Topeka, La Grande, Boise and other places who are perfectly decent people, but they are not whizzes with the tax code. Then you get a personal confrontation between the taxpayer and the IRS. The lawyer eventually gets into it and it escalates.

That, in my mind, is where the really bad cases come from, not from malevolence on the part of the IRS or from the IRS being out to get taxpayers. The bad cases frequently result from an unfortunate combination of a modestly trained IRS person, a very well trained tax lawyer, and an irate taxpayer.

That, in my mind, is where the really bad cases come from, not from malevolence on the part of the IRS or from the IRS being out to get taxpayers. The bad cases frequently result from an unfortunate combination of a modestly trained IRS person, a very well trained tax lawyer, and an irate taxpayer.

...
I think the income tax will exist in some form even if we moved to Chairman Archer’s national sales tax or some form of that.

As for the Tax Code Termination Act, I believe it provides that if Congress has not enacted a substitute by July 1, 2001, then the present tax code continues in existence. If that is the case, then picture this scenario. It is now April of 2001 and the current income tax is going to run out at the end of the year. The annual federal budget at that stage will be about $2.1 trillion. I assume Congress will not let Social Security taxes run out, so we have taken care, more or less, of Medicare and Social Security. But, that leaves things like military retirement, federal civilian retirement, Medicaid, and defense unfunded, and the clock will be ticking on passage of a complete substitute for the income tax code. Congress will enact some revenue measures to fund these programs (and others). But, my hunch is that Congress will simply extend the current tax code another three years or five years, maybe making some modest changes like those that would be made in any tax bill. There simply won’t be enough time to rethink the entire tax system before the deadline and, at the same time, the revenue has to be raised to run the government. You’ll basically end up with a Christmas tree tax bill, with the same kind of things that would be hung on any normal tax bill and the current tax code will be extended.

Q How has the process of writing tax bills changed since the 1986 Act (for better or worse), and what has caused those changes?

A The process of all legislation has changed. It’s not just taxes. The easiest way to view the changes is by looking over my career, which started in 1969 and ended in 1995. When I went to Congress, the most advanced word processing you had was an old IBM typewriter called an MTST, which ran on tapes. When you wanted to type letter 38, you had to wheel the tape around until it came to number 38 and then you pushed it and the letter was typed up. That was word processing. There were no faxes. Long distance telephone access was limited. We did have an internal government system called FTS, which allowed you to call other government offices, but you could not call long distance to every place in the country. And, you had many fewer lobbying groups, which I’ll refer to as “special interest” groups. However, I don’t regard that as a pejorative term. A special interest group is nothing more than a group of teachers or farmers or carpenters that have their own interests. It could even be tax lawyers, amazingly!

The first thing that has occurred is a fracturing of the special interest groups into smaller, more zealous groups, who almost become one-issue groups. If you are not with them on their issue, they are against you. In 1969, the American Medical Association, by and large, spoke for doctors. Now, there must be at least 10 to 20 specialized doctor groups. The AMA is becoming less influential and the individual special interest groups have become more influential and, not surprisingly, they see the world through their own eyes. If you can’t see the world through their eyes, then there is something wrong with you. They can’t understand why you don’t understand the problem the way they know it exists. If you were to say to a pediatrician, “Yes, but I had the orthopedist in yesterday and I had the anesthesiologist in as well,” he would undoubtedly say that the other docs don’t know what they are talking about because the real problem is the way he views it. Environmental groups are another example. You didn’t have Earth First in 1969, but you had some long-time groups like the Wildlife Federation, and now there are a whole range of environmental groups on various issues. In fact, it could be any issue. For a long period of time there was an element like that on Vietnam. They didn’t care what else you voted for. If you supported our military efforts in Vietnam, they were against you. So, you have this fracturing of interest groups over the years.

The second factor is the rapidity with which interest groups can communicate with their members and get, literally within the hour, phone calls and telegrams sent directly to your Capitol Hill office. There are even companies now that call you up and they say, “Mr. Hanson, what do you think about the capital gains tax? Oh, you think we ought to get rid of it. Would you like to talk to your Senator?” If the constituent is willing, they are plugged right into the Senator’s office. Right then, while the constituent waits on the line. None of that existed previously. When I first arrived in Congress, I’ll say that 90% of the letters I got were personal. By the time I left, 95% were instigated by interest groups. So, all of that has changed.

When it came time to write a tax bill, I found that most members wanted to take care of their constituents. Of course, everybody does. Russell Long of Louisiana wanted to take care of oil. He got hit over the head with it, but why on earth wouldn’t he want to take care of oil and gas. I wanted to take care of timber. California likes to take care of wine. These are your constituents. But, apart from that, I found that most members genuinely wanted to do what they thought was in the national interest if they could. That wasn’t always easy to do, however. But, it was easier to do before the passage of the Sunshine laws (which required public business to be done in the open). When an interest group came in, you would say, “Gosh darn, I tried to support you. I really did. The chairman bent my arm. I did everything I could.” Then, to protect yourself, you would tell the chairman that when those guys came in, to tell them that you really fought hard on their issue.

Today, if you put together a tax bill, or any bill for that matter, in the open, you
better not make the mistake of saying on Tuesday that you will consider it on Thursday, or you will have an absolute plethora of opposition (and not much support) on Tuesday afternoon and Wednesday to whatever it is that you are trying to do. The whole process becomes harder. Members of Congress are human. They kind of hate to say “no” when everybody is asking them to say “yes” and not very many people are asking them to say “no.” This is when politicians are often accused of double speaking. If you came in to talk to me, and I say, “That’s a well thought out presentation. That’s one of the better presentations that I have seen. By golly, maybe that’s the best one I’ve seen, I’ll take that under serious consideration.” You’ll go away thinking that I said that I was going to support you. I haven’t said I was going to support you. So, you feel double-crossed, but it’s because I don’t want to say, “Are you out of your mind? Do you think anybody cares about that idea?” If you have to do things in public, then all of those little groups that are convinced they know that the earth is flat, come to you and just beat you over the head. That’s the biggest difference I’ve seen. So, you find the Finance Committee now, justifiably in my mind, meeting in the back room and reaching decisions, and then going out and voting on them. Did they vote in public? You bet. But, did they reach the decisions in public? No!

In 1986, the core group that Pat Moynihan refers to was meeting in my office. I would meet my staff at 7:30 a.m., including Bill Diefenderfer, Lindy Paul and the others. I would use that time with my staff to decide what I wanted to try to get the core group to do. The core group would come in at 8:30 a.m. There were six of them and they were zealous. Senator Bradley (D-NJ) was there, along with Senators Danforth (R-MO), Chafee (R-RI), Moynihan (D-NY), Wallop (R-WY) and Mitchell (D-ME). Pat Moynihan displayed the most courage of the core group. I say that because he clearly had the most to lose. Some of the things we did affected some of our constituents, but EVERYTHING we did affected all of his constituents. It didn’t matter what it was, whether it was passive losses or capital gains or anything else, everything affected him and he never flinched for a second. If you have seven in the core group out of 20 members on the Finance Committee, and then you go to a mark-up at 10:00 a.m. and all your core group shows up and one or two others don’t show up, you can get the bill through the committee. Was this process done in an open forum? No. That’s the biggest difference I’ve seen and it isn’t just taxes, it applies to all legislation. More and more fractured special interest groups are involved, which makes the whole process more difficult. Let me emphasize this again, a “special interest” group is not a pejorative term, it’s just a group that has a narrowly targeted interest. It’s their lifetime interest. It may be saving the whales. They come very close to voting solely on their issue. In elections, it isn’t critical that a group can get 51% against you. It’s whether they can turn 4% of the vote against you that otherwise would have been with you. That’s how the elections in that 52 to 48 margin are lost. That is the frustration, but it is not limited to taxes.

Q In a matter of only a few years, we have seen the federal budget transform from actual and projected deficits in the range of $200 billion per year to large projected surpluses. Will the era of budget surpluses continue and, if it does continue, how will it affect tax legislation? Is it fair to make a comparison with the circumstances that led to a large tax cut being enacted in 1981, which was then followed by a large tax increase the next year?

A I frankly can’t predict whether the projected surpluses will come to fruition, although I do remember the circumstances that led to the enactment of TEFRA in 1982 when Bob Dole was Chairman of the Finance Committee. The country was in a recession. In retrospect, you have to question whether that was the time to raise taxes, when revenues are falling and you are in a recession. But there was the fear that we had better try to come closer to balancing the budget, although we didn’t come close. The problem, of course, was that we didn’t foresee the immense deficits when the tax cuts were enacted in 1981. So, in that sense, the situation that we faced in 1981 could be the same as what is happening this year.

CBO has projected a $1.6 trillion surplus over the next 10 years. Let’s say we have a trillion dollars to spend on taxes and tax cuts (with $600 billion set aside for Social Security) and we do it. And then, a year later, the economy slows down. It turns out that we don’t have a trillion dollar surplus for tax cuts over ten years. You actually have only $400 billion over ten years and you are now $60 billion short each year. At that stage, it would be particularly interesting if you were short not because you are in a recession, but because the economy was growing at 1% a year instead of 2% a year. You are not going backwards, but you are still short. I don’t know what Congress would do. But the circumstances would be almost identical to what Reagan faced because, as I said, we were projecting surpluses in 1981; we weren’t assuming a deficit. We thought by cutting taxes we would get rid of the surplus and the President, I think, correctly thought that if we didn’t get rid of the surplus Congress would spend it.

It is also interesting that many people continue to believe that Reagan cut taxes in the face of looming deficits in 1981, which is completely wrong. Every now and then I give speeches on this subject and the first thing I attempt to do is disabuse various notions about the 1981 budget projections. It is becoming an absolute myth that Reagan didn’t care if he widened the deficit. We got
To me, the biggest problem is the taxpayers that have income of somewhere in the range of $50,000 to $200,000 from running a small or modest size business. It isn’t just the tax code that confronts and confounds them, although it certainly does. They are faced with environmental codes, the Americans with Disabilities Act, and numerous other statutory and regulatory guidelines, none of which they can understand and all of which apply to them. They are just frustrated beyond belief. The worst part of the tax code is the incapacity of an honest, intelligent taxpayer to understand it.
them, although it certainly does. They are faced with environmental codes, the Americans with Disabilities Act, and numerous other statutory and regulatory guidelines, none of which they can understand and all of which apply to them. They are just frustrated beyond belief. The worst part of the tax code is the incapacity of an honest, intelligent taxpayer to understand it.

Q Senator, we have completed our questions. Do you have any other comments?

A I’ll give you a wonderful story on the '86 Tax Act. I get a kick out of the press who are convinced that money and campaign donations are the only things that determine the shape of legislation. Big tobacco gives money, therefore there is no tobacco bill this Congress. Big doctors give, therefore there is no Clinton health plan. In my experience, money is pretty far down the list of those things you listen to. I think there may be a game that politicians play. Sort of like me saying to you, “Jack, I think that’s a good idea. Let me think that over.” You go away. My staff then says, “Bob, you are not seriously thinking about that. That guy is out of his mind.” What happens is that you actually let donors think that their contribution matters.

Think about it in this context. Your Senate campaign costs anywhere from $2 to 10 million, but the most a donor and spouse can give you, including both the primary and the general election, is $4,000, and that’s if they give you a thousand each in the primary and a thousand each in the general. Political Action Committees also give you money. The railroad lobby gives you money and the trucking lobby gives you money. Do you think they like each other? Do you think they will agree with each other when some piece of legislation comes along involving transportation? Of course not, they’re like oil and water.

In my experience, there are four groups of people that you listen to, long before you even get to money. One is constituents. You bet you listen to constituents. Your scheduling secretary bends over backwards to let constituents in. Do you agree with them necessarily? No, but you treat them courteously and they get in. The second group is your former staff that was with you four, five or six years. You trust them. If I was in the Senate and Lindy Paul was practicing law and she wanted to come and see me, do you think she could get in? You bet! Just like that, she’s in. Bill Diefenderfer, who led the Finance Committee in ’86 and then was Deputy Budget Director at OMB, he could get in any time he wanted. Third, are campaign workers who had given you time. Would you rather have a thousand dollar contribution or a thousand hours of someone’s time? Anybody, within reason, can give you time. Fourth, are your old friends. People who went through fire with you when you were 25. Maybe you were on the school board with them when the issue of charter schools or something came up and you and he had to fight back-to-back to get out the backdoor safely. He’s gone back to practicing law and it’s now 25 years later and you’re a Senator. Do you think he can get in to see you? You bet he can get in to see you. It doesn’t matter who he is now.

Having said all that, here is a funny story. There was a provision that the savings and loan industry wanted in 1986. I can’t remember what it was. My closest friend in Portland, Dave Barrows, was a fraternity brother and he was also a lobbyist at the Oregon legislature, not here in Washington. When I first ran for the legislature in 1962, he went out door-to-door for me 19 out of 20 nights just because we were close friends. He also happened to represent the Oregon Savings & Loan League. The Washington office for the S&Ls was smart enough to realize that they ought to have him call me if they had an issue, rather than their national lobbyist here in Washington, who I didn’t even know. Dave called me from Oregon and asked whether I could help him on the issue. I thought it had merit anyway, but I wanted to help my friend, Dave, who I think to this day probably has not given me any money. So, I’m talking with Dan Rostenkowski as we’re attempting to do the ‘86 Conference Report. The two committees (Ways & Means and Finance) had delegated to Danny and me the task of negotiating the conference agreement. The two of us were meeting with only about five or six staff to determine what to do with five trillion dollars worth of revenues. I finally said, “Danny, I’ve got to have this savings and loan provision.” He said, “Are you out of your mind pal. That hasn’t got any merit. I’m not going to give you that.” I said, “Danny, I’ve got to have it” He said, “Don’t even bother to bring it up. I’m telling you it ain’t worth it and you can’t have it. I don’t care how many times you ask for it.” I finally said, “Danny, I have to have it.” He said, “Why?” I explained that it was for my old friend Dave Barrows, a fraternity brother who stuck his neck out when I ran for the legislature and he was the only lobbyist in Oregon who supported me when I ran against Senator Morse. It would have ruined Dave’s career had I lost and I just had to do it for him. Danny said, “Well, for Heaven’s sake why didn’t you explain it that way before. Why did you waste my time. Of course, we’ll put it in the bill.”

Well, three or four days go by. We’re in Danny’s backroom and he says to me, “Hey, pal, come here. Remember your friend in the savings and loan industry?” I said, “Yeah.” Well, he says, “I got a friend too.” I said, “Oh!” As it turned out, his friend needed a $400 million capital gains grandfather provision. That was something we had not done for anybody in the bill up to that point and so I told Bill Diefenderfer, Lindy Paul and John Colvin that we had to give it to him, but we had to disguise it somehow. This was a case where there was no money changing hands for either of us and certainly no campaign contributions at stake. My hunch is that this is roughly the same way the PTA works or the Board of Directors of the YMCA works, where friendship means infinitely more than money.
account). Unless the article indicates otherwise, all holdings are in the same stock mutual fund. I use the term “liquidation date” as the date on which I shall liquidate the accounts, which is not necessarily the date on which I retire from the workforce.

If I convert the $200 in the traditional IRA account to a Roth, I must pay $100 in ordinary income tax. In effect, for $100, I am buying out the Service’s 50% “partnership” interest. In other words, if I give the Service my outrightly owned $100 account (and pay any capital gains tax due on that account), the Service conveys to me its half ownership in the $200 traditional IRA account.

I start out with $100 outright and $200 in a 50% “partnership” with the Service. I end up with $200 in a Roth IRA that I own entirely. I give up $100 to get $100. Ignoring the capital gains tax due, from a net worth perspective the result is a wash. My net worth remains $200.

Nevertheless, the Roth conversion results in certain immediate and long-term advantages. First, before conversion, dividends and capital gains on the $100 non-IRA account were subject to income tax. After conversion, dividends and capital gains on my Roth IRA account are not subject to income tax, and all $200 of this account is now mine (versus only $100 earlier). Second, unlike the traditional IRA, my Roth IRA has no required minimum distributions starting at age 70½. I can keep the Roth IRA until I die and leave the entire amount to my spouse (or my child or grandchild), who may take distributions over her lifetime and never pay income tax of any sort. My analysis ignores certain proposals made by President Obama. He has proposed that the Roth IRA be subject to the same required minimum distributions as the traditional IRA. He has also proposed a five-year required minimum distribution period for non-spousal beneficiaries of all 401(k)s, IRAs, and similar vehicles. See Andrea Coomber, *Beware Leaving a Roth for Heirs: The Idea Makes Sense, but New IRA Rules Could Make the Decision Harder*, WALL ST. J., Sept. 8, 2014, at R6.

The chart below summarizes the results of the analysis in this article and its Appendixes. It assumes a constant flat ordinary income tax rate.

### The Effect of Paying Capital Gains Tax on the Amount Used to Pay the Ordinary Income Tax Resulting from Conversion

Because the Code requires me first to liquidate the $100 non-IRA account, pay capital gains tax, and then pay the $100 ordinary income tax for the Roth conversion, my analysis must take both taxes into account. On the $100 non-IRA account, I shall artificially assume a zero basis. For ease of calculation, I shall also assume two alternative constant capital gains tax rates: either 20% or 50%. (Later, I shall alternatively assume a tripling, doubling, or halving of all the mutual fund accounts.) Thus, to finance the ordinary income tax on the Roth conversion, I must liquidate the $100 non-IRA account (also referred to as the second account) and pay capital gains tax of either 20% or 50% of $100 ($100 minus the zero basis): either $20 or $50. For simplicity, I assume that I have this $20 or $50 in a savings account (also referred to as the third account).

With the Roth conversion, I would have $200 in a Roth IRA. Without the Roth conversion, I would have the following: (1) a $200 traditional IRA in effect half owned by the Service, making my net ownership interest $100; (2) $100 in a zero-basis non-IRA account, subject to capital gains tax at liquidation; and (3) either $20 or $50 in a savings account. Assume that I switch the $20 or $50 to an account with the same stock mutual fund as the others.

At some hypothetical date called “liquidation,” I shall assume liquidation (without penalty) of either the Roth IRA or all three of the alternative accounts. (On the one hand, the first option, liquidation of the Roth, removes the advantage of holding the tax-free Roth IRA until my death and leaving it to a beneficiary who then holds the tax-free Roth for some period. On the other hand, the other option, liquidation of the

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<th>Zero basis on $100 non-IRA account; 23.8% capital gains rate at possible conversion; 15% capital gains rate at liquidation</th>
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<td>Triple in Value</td>
<td>Roth better</td>
<td>Roth better</td>
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three alternative accounts, eliminates the benefit of a stepped-up basis at death on the two non-IRA accounts.

**Account Values Triple**

Suppose that by the liquidation date, all the mutual fund accounts triple in value with reinvestment of all dividends and capital gains distributions. With the Roth conversion, I would have $600 in a Roth IRA, exempt from all income tax. Without the Roth conversion, I would have: (1) $600 in a traditional IRA, in effect half owned by the Service; my net ownership interest is $300; (2) $300 in a non-IRA account owned outright minus capital gains tax at liquidation; and (3) either $60 or $150 in another non-IRA account owned outright minus capital gains tax at liquidation. On the second and third accounts, I would also have had to pay tax on any interim dividends and capital gains distributions.

Assume that at the liquidation date, my capital gains tax rate is the same as at possible conversion: either 20% or 50%. Without the Roth conversion, were I to liquidate the $300 second account, I would pay either 20% or 50% on the capital gains of $300 ($300 minus the $0 basis): either $60 or $150. That is exactly the amount in the third account. In other words, as long as the capital gains rate is constant over time, the amount in the third account is exactly equal to the capital gains tax due on the second account. (For the moment, I shall ignore the upward adjustment of the zero basis resulting from the reinvested dividends and capital gains distributions.)

On the third account, the capital gains tax at liquidation is either $8 or $50: 20% of $40 ($60 minus the preliminary unadjusted $20 basis) or 50% of $100 ($150 minus the preliminary unadjusted $50 basis). After this preliminary capital gains tax, the $52 or $100 in the third account is less than the either $60 or $150 necessary to pay the preliminary capital gains tax on the second account. Initially, the Roth conversion appears better.

The above analysis ignores two countervailing factors: (1) the non-Roth detriment of interim taxes on the dividends and capital gains distributions (on the second and third accounts); and (2) the non-Roth benefit of the tax advantage of the upward basis adjustment resulting from the reinvested dividends/distributions (for those same two accounts).

The non-Roth detriment of interim taxes on the dividends and capital gains distributions in the second and third accounts compounded to future value at the liquidation date should be worth more than the non-Roth benefit of the tax advantage of the upward adjustment of basis on the same two accounts. The Roth conversion should be better.

Note that the amount in the third account is exactly the same as the preliminary capital gains tax on the second account (with the unadjusted basis). Therefore, another way of coming to the same conclusion is to compare (1) the above non-Roth detriment, plus the capital gains tax on the liquidation of account three, with (2) the above non-Roth benefit. The first amount should exceed the second, and the Roth conversion should be better.

**Account Values Double**

Alternatively, by the liquidation date, assume that all the accounts only double in value with all dividends and capital gains distributions reinvested. With the Roth conversion, I would have $400 in a Roth IRA. Without the Roth conversion, I would have: (1) $400 in a traditional IRA, in effect half owned by the Service; my net ownership interest is $200; (2) $200 in a non-IRA account, minus capital gains tax at liquidation; and (3) either $40 or $100 in another non-IRA account, minus capital gains tax at liquidation. On the second and third accounts, I would also have had to pay tax on any interim dividends and capital gains distributions.

Assume that at the liquidation date, my capital gains tax rate is the same as at possible conversion: either 20% or 50%. Without the Roth conversion, were I to liquidate the $200 second account, I would pay either 20% or 50% on the capital gains of $200 ($200 minus the preliminary unadjusted $0 basis): either $40 or $100. As before, that is exactly the amount in the third account.

On the third account, the capital gains tax at liquidation is either $4 or $25: 20% of $20 ($40 minus the preliminary unadjusted $20 basis); or 50% of $50 ($100 minus the preliminary unadjusted $50 basis). After this preliminary capital gains tax, the $36 or $75 in the third account is less than either the $40 or $100 necessary to pay the preliminary capital gains tax on the second account. Initially, the Roth conversion appears better.

Again, the above analysis ignores two countervailing considerations: (1) the non-Roth detriment of the interim taxes on the dividends and capital gains distributions (on the second and third accounts) and (2) the non-Roth benefit of the tax advantage of the upward basis adjustment resulting from the reinvested dividends/distributions (for those same two accounts).

The non-Roth detriment of the interim taxes on the dividends and capital gains distributions in the second and third accounts compounded to future value at the liquidation date should be worth more than the non-Roth benefit of the tax advantage of the upward adjustment of basis on the same two accounts. The Roth conversion should be better.

Again, note that the amount in the third account is exactly the same as the preliminary capital gains tax on the second account (with the unadjusted basis). Therefore, another method of demonstrating the same point is to compare: (1) the above non-Roth detriment, plus the capital gains tax on the liquidation of the third account with (2) the above non-Roth benefit. The first
Account Values Are Halved

Alternatively, by the liquidation date, assume that all the accounts fall by 50% with all dividends and capital gains distributions reinvested. With the Roth conversion, I would have $100 in a traditional IRA. Without the Roth conversion, I would have: (1) $100 in a traditional IRA, in effect half owned by the Service; my net ownership interest is $50; (2) $50 in a non-IRA account, minus capital gains tax at liquidation; and either $10 or $25 in another non-IRA account. On the second and third accounts, I would also have had to pay tax on any interim dividends and capital gains distributions.

Assume that at the liquidation date, my capital gains tax rate is the same as at possible conversion: either 20% or 50%. Without the Roth conversion, were I to liquidate the $50 second account, I would pay either 20% or 50% on the capital gains of $50 ($50 minus the preliminary unadjusted $0 basis): either $10 or $25. As before, that is exactly the amount in the third account.

On liquidation of the third account, the preliminary capital loss is either $10 or $25: $10 minus the preliminary unadjusted $0 basis: either $10 or $25. As before, that is exactly the amount in the third account.

The above analysis ignores two countervailing factors: (1) the non-Roth detriment of the interim taxes on the dividends and capital gains distributions (on the second and third accounts), plus the decrease in capital loss resulting from the upward basis adjustment in the third account, versus (2) the non-Roth benefit of the tax advantage of the upward basis adjustment resulting from the reinvested distributions for the second account.

As before, the amount in the third account is exactly the same as the preliminary capital gains tax on the second account (with the unadjusted basis). Therefore, whether the Roth conversion is beneficial depends on a comparison of (1) the non-Roth detriment compounded to future value at the liquidation date (the interim taxes on the dividends and capital gains distributions in the second and third accounts) with (2) the non-Roth benefit (the tax advantage of the upward adjustment of basis in the second account) plus the tax advantage of the capital loss of on the liquidation of the third account adjusted downwards to reflect the upward adjustment of basis resulting from the reinvestment of dividends and capital gains distributions. The relative value of the two amounts is unclear, so the Roth conversion may or may not be advantageous.

Summary

This article assumes the payment of capital gains tax on the asset liquidated to pay the ordinary income tax on the Roth conversion. Nevertheless, the conversion avoids future capital gains and other income tax on the amount converted.

Future investment appreciation cuts both ways. On the one hand, the greater the appreciation, the larger the opportunity cost of the funds used to pay the capital gains tax (on the asset liquidated to pay the ordinary income tax on the amount converted). On the other hand, the higher the appreciation, the bigger the tax savings resulting from the conversion.

The tax savings are more than the opportunity cost of the capital gains tax paid on the asset sold to finance the conversion under certain assumptions: (1) constant flat ordinary income and capital gains tax rates; (2) a zero basis on the asset that would be sold to finance the ordinary income tax due upon conversion; (3) the possession of enough cash to pay the capital gains tax at conversion; and (4) an equal increase in the Roth account or, alternatively, the traditional IRA account and the non-IRA accounts holding the amounts that would have been paid in tax upon conversion.

One of several illustrations assumed a constant flat ordinary income tax rate of 50% and a constant flat capital gains tax rate of either 20% or 50%. The illustration also postulated three accounts: (1) a $200 traditional IRA account that might be converted to a Roth; (2) a zero basis $100 non-IRA account that might be liquidated to pay the $100 income tax (50% of $200) on the Roth conversion; and (3) either $20 or $50 in a savings account that might be used to pay the capital gains tax on the second account were it liquidated to pay the ordinary income tax for the Roth conversion of the first account. Without the Roth conversion, I assume that this $20 or $50 is switched to an account with the same stock mutual fund as the others.
With the Roth conversion, I have $200 in a Roth IRA account. Without the conversion, I have the three accounts above. At the hypothetical account liquidation date, I assume liquidation (without penalty) of either the Roth IRA or all three accounts.

Regardless whether all accounts triple or double by the liquidation date (with reinvestment of all dividends and capital gains distributions), the amount in the third account is exactly the same as the preliminary capital gains tax due on the second account (with no upward adjustment in basis for the reinvested dividends and capital gains distributions). Initially, the two alternatives (Roth or no Roth) seem equivalent.

The correct analysis is more complicated. One comparison is of the following two dollar amounts: (1) (non-Roth detriment) the interim taxes on the dividends and capital gains distributions in the second and third accounts compounded to future value at liquidation of the two accounts, plus the capital gains tax on the liquidation of the third account with (2) (non-Roth benefit) the tax advantage of the upward adjustment of basis of the second and third accounts because of the reinvestment of the same dividends/distributions. The first amount should exceed the second, and the Roth conversion should be better.

If, instead of appreciating, the accounts decline in value by the liquidation date, assuming a constant capital gains rate, the Roth conversion might be better or worse.

The Appendices illustrate some alternative possibilities. One assumes a 23.8% capital gains rate at possible conversion and a $40 (rather than a zero) basis on the $100 second account (that would be liquidated to pay the ordinary income tax on the conversion). In that situation, if the accounts appreciate between possible conversion and the liquidation date, the Roth conversion should generally be advantageous even with a lower 15% capital gains tax at liquidation; on the other hand, if the accounts decline in value between possible conversion and liquidation, the conversion may be better or worse but would often be worse (again assuming a lower 15% capital gains tax rate at liquidation).

Other Appendix examples assume (1) a 23.8% capital gains tax rate at possible conversion; (2) a zero basis on the second account (the capital asset that would be sold to finance the Roth conversion); and (3) a lower 15% capital gains tax rate at liquidation than the 23.8% rate at possible conversion. Under these circumstances, the conversion may be better or worse but would often be worse. The net result depends in part on the size of the interim taxes on dividends and capital gains distributions paid in the absence of the conversion.

This article’s analysis makes a great many simplifying assumptions. The major one is the constant and uniform ordinary income tax rate. In reality, this rate is neither constant nor uniform. My conversion of a large amount to a Roth might thrust me into a higher marginal income tax bracket. In addition, I do not know what my marginal ordinary income tax rate will be at the time all the accounts are liquidated. Nevertheless, the analysis with its simplifying assumptions demonstrates the potential advantage of a Roth IRA conversion even when financed by the sale of a capital asset with accompanying capital gains tax.

APPENDIXES

Again, suppose I start with two accounts holding the same stock mutual fund: (1) a $200 traditional IRA account with a zero basis; and (2) a $100 account I own outright. As before, assume that the federal ordinary income tax rate will be a flat 50% forever and there will be no state income or capital gains taxes.

If I convert the $200 in the traditional IRA account to a Roth, I must pay $100 in ordinary income tax. In effect, for $100, I am buying out the Service’s 50% “partnership” interest. In other words, if I give the Service my out rightly owned $100 account (the second account) and pay any capital gains tax due on that account, the Service conveys to me its half ownership in the $200 traditional IRA account.

Appendix I

The analysis in Appendix I assumes a $40 basis in the second account instead of a zero basis. It also assumes a 23.8% capital gains rate (20% maximum federal capital gains tax rate plus the 3.8% federal tax on investment income) at the time of converting the traditional IRA to a Roth and possession of enough cash to pay the capital gains tax at conversion. Finally, it assumes a 15% capital gains tax rate at the eventual liquidation date.

To finance the ordinary income tax on the Roth conversion, I must liquidate the second account and pay capital gains tax of 23.8% of $60 ($100 minus the $40 basis): $14.28. For simplicity, I assume that I have this $14.28 in a savings account.

With the Roth conversion, I would have $200 in a stock mutual fund Roth IRA. Without the Roth conversion, I would have the following: (1) a $200 stock mutual fund traditional IRA in effect half owned by the Service; my net ownership interest is $100; (2) $100 in a stock mutual fund owned outright, subject to capital gains tax at liquidation; and (3) $14.28 in a savings account owned outright. Assume that I switch the $14.28 to an account with the same stock mutual fund as the others.

Again, at some hypothetical date called “liquidation,” I shall assume liquidation (without penalty) of either the Roth IRA or all three of the alternative accounts.

Account Values Triple

Suppose that by the liquidation date, all the mutual fund accounts triple in value with reinvestment of all dividends and capital gains distributions. With the
Roth conversion, I would have $600 in a Roth IRA, exempt from all income tax. Without the Roth conversion, I would have: (1) $600 in a traditional IRA in effect half owned by the Service; my net ownership interest is $300; (2) $300 in a non-IRA account owned outright minus capital gains tax at liquidation; and (3) $42.84 in another non-IRA account owned outright minus capital gains tax at liquidation. On the second and third accounts, I would also have had to pay tax on any interim dividends and capital gains distributions.

Assume that at the liquidation date, my capital gains tax rate is only 15%. Without the Roth conversion, were I to liquidate the $300 second account, I would pay 15% of the capital gains of $260 ($300 minus the $40 preliminary unadjusted basis): $39.

Capital gains tax on liquidation of the $42.84 third account would be 15% of $28.56 ($42.84 minus the preliminary unadjusted $14.28 basis): $4.28. The preliminary net liquidation amount for the third account would be $42.84 minus $4.28: $38.56. That is only 44 cents less than the preliminary $39 capital gains tax due on liquidation of the second account. Initially, the Roth conversion appears slightly better.

Again, the above analysis ignores two opposite effects: (1) the non-Roth detriment of interim taxes on the dividends and capital gains distributions (on the second and third accounts) and (2) the non-Roth benefit of the tax advantage of the upward basis adjustment resulting from the reinvested dividends/distributions (for the same two accounts). Because this variation assumes a 15% capital gains tax at the liquidation of the two accounts, the non-Roth tax advantage of the upward basis adjustment is less than with a 23.8% capital gains tax rate.

Account Values Double

Alternatively, by the liquidation date, assume that all the mutual funds only double in value with reinvestment of all dividends and capital gains distributions. With the Roth conversion, I would have $400 in a Roth IRA. Without the Roth conversion, I would have: (1) $400 in a traditional IRA, in effect half owned by the Service; my net ownership interest is $200; (2) $200 in a non-IRA account minus capital gains tax at liquidation; and (3) $28.56 in another non-IRA account minus capital gains tax at liquidation. On the second and third accounts, I would also have had to pay tax on any interim dividends and capital gains distributions.

Assume that at the liquidation date my capital gains tax rate is only 15%. Without the Roth conversion, were I to liquidate the $200 second account, I would pay 15% of the capital gains of $160 ($200 minus the preliminary unadjusted $40 basis): $24.

Capital gains tax on liquidation of the $28.56 third account would be 15% of $14.28 ($28.56 minus the preliminary unadjusted $14.28 basis): $2.14. The preliminary net liquidation amount for the third account would be $28.56 minus $2.14: $26.42. That is $2.42 more than the preliminary $24 capital gains tax due on liquidation of the second account. Initially, the Roth conversion seems better.

Account Values Are Halved

Alternatively, by the liquidation date, assume that all the mutual funds fall by a half with all dividends and capital gains distributions reinvested. With the Roth conversion, I would have $100 in a Roth IRA. Without the Roth conversion, I would have: (1) $100 in a traditional IRA; (2) $50 in a non-IRA account, minus capital gains tax at liquidation;
and (3) $7.14 in another non-IRA account. On the second and third accounts, I would also have had to pay tax on any interim dividends and capital gains distributions.

Assume that at the liquidation date, my capital gains tax rate is only 15%. Without the Roth conversion, were I to liquidate the $50 second account, I would pay 15% on the capital gains of $10 ($50 minus the preliminary unadjusted $40 basis): $1.50. The $7.14 in the third account is $5.64 more than the $1.50 capital gains tax on the second account. In addition, on liquidation of the third account, the preliminary capital loss is $7.14: $7.14 minus the preliminary unadjusted $14.28 basis. Initially, the Roth conversion appears worse because of the tentative $5.64 “excess” in the third account at liquidation plus the absence of the preliminary capital loss of $7.14.

The above analysis ignores two countervailing factors: (1) the non-Roth detriment of the interim taxes on the dividends and capital gains distributions (on the second and third accounts), plus the decrease in capital loss resulting from the upward basis adjustment in the third account (resulting from the reinvested dividends/distributions), versus (2) the non-Roth benefit of the tax advantage of the upward basis adjustment in the second account (resulting from the reinvested dividends/distributions).

Because this variation assumes a 15% capital gains tax at the time of liquidation of the two accounts, the tax effect of both the capital loss and the upward basis adjustment is less than with a 23.8% capital gains tax rate.

Compounded to future value at the time of liquidation of the two accounts, the non-Roth detriment of interim taxes on the dividends and capital gains distributions in the second and third accounts may be worth more or less than the following non-Roth benefits: (1) the tax advantage of the upward adjustment of basis on the second account, plus (2) the tax advantage of the preliminary capital loss of $7.14 on the third account adjusted downwards to reflect the upward adjustment of basis resulting from the reinvestment of dividends and capital gains distributions, plus (3) the tentative $5.64 “excess” in the third account. The Roth conversion may be better or worse but would often be worse.

Appendix II

The analysis in Appendix II assumes a zero basis in the second account instead of a $40 basis. It also assumes a 23.8% capital gains rate (20% maximum federal capital gains tax rate plus the 3.8% federal tax on investment income) at the time of converting the traditional IRA to a Roth and possession of enough cash to pay the capital gains tax at conversion. Finally, it assumes a 15% capital gains tax rate at the eventual liquidation date.

To finance the ordinary income tax on the Roth conversion, I must liquidate the second account and pay capital gains tax of 23.8% of $100 ($100 minus the $0 basis): $23.80. For simplicity, I assume that I have this $23.80 in a savings account.

With the Roth conversion, I would have $200 in a stock mutual fund Roth IRA. Without the Roth conversion, I would have the following: (1) $200 in a stock mutual fund traditional IRA in effect half owned by the Service; my net ownership interest is $100; (2) $100 in a stock mutual fund owned outright, subject to capital gains tax at liquidation; and (3) $23.80 in a savings account owned outright. Assume that I switch the $23.80 to an account with the same stock mutual fund as the others.

Account Values Triple

Again, suppose that by the liquidation date, all the mutual fund accounts triple in value with reinvestment of all dividends and capital gains distributions. With the Roth conversion, I would have $600 in a Roth IRA, exempt from all income tax. Without the Roth conversion, I would have: (1) $600 in a traditional IRA in effect half owned by the Service; my net ownership interest is $300; (2) $300 in a non-IRA account owned outright minus capital gains tax at liquidation; and (3) $71.40 in another non-IRA account owned outright minus capital gains tax at liquidation. On the second and third accounts, I would also have had to pay tax on any interim dividends and capital gains distributions.

Suppose, at the liquidation date, my capital gains tax rate is only 15%. Without the Roth conversion, were I to liquidate the $300 second account, I would pay 15% on the capital gains of $300 ($300 minus the preliminary unadjusted $0 basis): $45.

Were I to liquidate the $71.40 third account, the capital gains tax would be 15% of $47.60 ($71.40 minus the preliminary unadjusted $23.80 basis): $7.14. After this preliminary $7.14 capital gains tax, the $64.26 in the third account is $19.26 more than the $45 necessary to pay the preliminary capital gains tax on the second account. Initially, the Roth conversion seems worse.

As before, the above analysis ignores two opposite factors: (1) the non-Roth detriment of the interim taxes on the dividends and capital gains distributions (on the second and third accounts) and (2) the non-Roth benefit of the tax advantage of the upward basis adjustment resulting from the reinvested dividends/distributions (for those same two accounts). Because this variation assumes a 15% capital gains tax at the liquidation date, the non-Roth tax advantage of the upward basis adjustment is less than with a 23.8% capital gains tax rate.

Compounded to future value at the time of liquidation of the two accounts, the non-Roth detriment of interim taxes on the dividends and capital gains distributions in the second and third accounts might be worth more or less than the non-Roth benefit of the tax advantage.
advantage of the upward adjustment of basis on the same two accounts plus $19.26 (the initial “excess” in the third account at liquidation). The Roth conversion might be better or worse but would often be worse.

Account Values Double

Alternatively, suppose that by the liquidation date, all the mutual funds only double in value with all dividends and capital gains distributions reinvested. With the Roth conversion, I would have $400 in a Roth IRA. Without the Roth conversion, I would have: (1) $400 in a traditional IRA, in effect half owned by the Service; my net ownership interest is $200; (2) $200 in a non-IRA account minus capital gains tax at liquidation; and (3) $47.60 in another non-IRA account minus capital gains tax at liquidation. On the second and third accounts, I would also have had to pay tax on any interim dividends and capital gains distributions.

Suppose at liquidation my capital gains tax rate is only 15%. Without the Roth conversion, were I to liquidate the $200 second account, I would pay 15% on the capital gains of $200 ($200 minus the preliminary unadjusted $0 basis): $30.

On liquidation of the $47.60 third account, the tentative capital gains tax is 15% of $23.80 ($47.60 minus the preliminary unadjusted $23.80 basis): $3.57. After this $3.57 tentative capital gains tax, the $44.03 in the third account is $4.40 more than the preliminary $7.50 capital gains tax on the second. On liquidation of the third account, the preliminary capital account is $11.90 ($11.90 minus the preliminary unadjusted $23.80 basis).

Initially, the Roth conversion appears worse because of the absence of the preliminary capital loss of $11.90 and the tentative $4.40 “excess” in the third account at liquidation.

Again, the above analysis ignores two opposite factors: (1) the non-Roth detriment of interim taxes on the dividends and capital gains distributions (on the second and third accounts) plus the decrease in capital loss resulting from the upward basis adjustment in the third account, versus (2) the non-Roth benefit of the tax advantage of the upward basis adjustment resulting from the reinvested distributions (for the second account). Because this variation assumes a 15% capital gains tax at the time of liquidation of the two accounts, the tax effect of both the capital loss and the upward basis adjustment is less than with a 23.8% capital gains tax rate.

Compounded to future value at the time of liquidation of the two accounts, the non-Roth detriment of the interim taxes on the dividends and capital gains distributions in the second and third accounts might be worth more or less than the non-Roth benefit of the tax advantage of the upward adjustment of basis on the two accounts plus $14.03 (the initial “excess” in the third account). The Roth conversion might be better or worse but would often be worse.

Account Values Are Halved

Alternatively, suppose that by the liquidation date, all the mutual funds do not appreciate but instead fall by a half with all dividends and capital gains distributions reinvested. With the Roth conversion, I would have $100 in a Roth IRA. Without the Roth conversion, I would have: (1) $100 in a traditional IRA, in effect half owned by the Service; my net ownership interest is $50; (2) $50 in a non-IRA account minus capital gains tax at liquidation; and (3) $11.90 in another non-IRA account. On the second and third accounts, I would also have had to pay tax on any interim dividends and capital gains distributions.

Again, at the liquidation date my capital gains tax rate is only 15%. Without the Roth conversion, were I to liquidate the $50 second account, I would pay 15% on the capital gains of $50 ($50 minus the preliminary unadjusted $0 basis): $7.50. The $11.90 in the third account is $4.40 more than the preliminary $7.50 capital gains tax on the second. On liquidation of the third account, the preliminary capital account is $11.90 ($11.90 minus the preliminary unadjusted $23.80 basis).

Initially, the Roth conversion appears worse because of the absence of the preliminary capital loss of $11.90 and the tentative $4.40 “excess” in the third account at liquidation. The Roth conversion may be better or worse but would often be worse.
**Tax Bites**

From the Low-Income Taxpayer Souvenir Songbook

By Paul R. Harrison*

**Section 61 Revisited**

*(To the tune of *Highway 61 Revisited* by Bob Dylan, 1965)*

Commish’ner said to Duberstein, “That’s income, son.”
Dube says, “Man, you must be puttin’ me on.”
Commish say, “No.” Dube say, “What?”
Commish say, “You can do what you want, Dube, but
The next time you file your taxes, declare all your income.”
Well, Dube, says, “Where’d you get this idea from?”
Commish says, “Out in Section 61.”

Well, Georgia Sam, he had his car repo’d
Then he got a demand for the tax he owed
He asked poor Howard, “What’s up here, bro?”
Howard said, “It’s income that much I know.”
Sam said, “It makes no sense to say I had income.”
Ol’ Howard just pointed with his thumb
And said, “It’s written right here in Section 61.”

Well, Mack the Finger said to Louie the King,
“On the sidewalk downtown, I found a diamond ring
And some bearer bonds and some other bling.
Will I have to pay taxes if I sell these things?”
And Louie the King said, “Let me think for a minute, son.”
And he said, “Yes, I think it’ll definitely be income.
“You’ll find it all explained in Section 61.”

Now, the fifth daughter on the twelfth night
Told the first father that things weren’t right
“My unemployment check,” she says, “is much too light.”

He said, “Come here. I think you’re right. Hmm, it’s just the income tax bite.
I recall the Second Mother told you to have withholding done.”
But the Second Mother was with the Seventh Son
And they were looking for exclusions from Section 61.

Now, the rovin’ gambler he was very bored.
He was tryin’ to account for the losses he’d scored.
He found an accountant who nearly fell off the floor.
He said, “That’s what you keep a win-loss diary for.
But, yes, I think it can be very easily done
We’ll just subtract the losers from all the bets you’ve won
And declare the difference according to Section 61.”

**With Math Error Authority**

*(To the tune of *A Whiter Shade of Pale* by Keith Reid and Gary Brooker, 1967)*

We filed our Form ten-forty
With software found online.
And using free e-filing,
We got it in on time.
Awaiting our big refund
Imagine our dismay
When the notice came informing us
That our tax return’d been changed.

And so it was that later, they assessed liability.
Explaining all the changes with Math Error Authority.

The notice gave no reason
That we could plainly see.
So we dial’d the eight-hundred number
And said, “We disagree
With those additions to our income
That we know we’ve never seen.
If we’ve ever worked in Illinois,
It comes as news to me.”

And so it was that later, they assessed liability.
Explaining all their changes with Math Error Authority.

They said, “Here is the reason,
And the truth is plain to see.
Your income has been reported
To us by employers electronic’ly.
Each of sixteen ‘scrim’nant functions
And document-matching coast to coast,
Confirm you’ve made these errors, so
Your refund now is toast.”

And so it was that later, they assessed liability.
Explaining all the changes with Math Error Authority.

* * * * *

* Director, Tax Clinic, Center for Economic Progress, Chicago, IL.*
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### Submissions and Comments on Government Regulations, Administrative Rulings, Blanket Authority and ABA Policy*

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