LEXIS® FEDERAL TAX JOURNAL QUARTERLY

March 2012

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Cite to article in this publication as:
Author name, Article name, [vol. no.] Lexis® Federal Tax Journal Quarterly [Ch. no.], § [sec. no.] [Matthew Bender]

Example:
Mary Riley, Mary Riley on Repatriation Tax Holidays and Territorial Tax Systems, March 2012 Lexis® Federal Tax Journal Quarterly 1, § 1.01 [Matthew Bender].

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Mary Riley on Repatriation Tax Holidays and Territorial Tax Systems

By Mary Riley, Ph.D., J.D.*

§ 1.01 Introduction

Legislative year 2011 saw bipartisan support for instituting broad corporate tax reform, although to what extent tax reform could stimulate the domestic economy is a hotly-debated subject in Washington. The debate over corporate tax reform has largely centered on lowering the corporate tax rate and, more radically, transitioning from a worldwide to a territorial system of international taxation.[1] Another proposal, designed to bring about tax relief more quickly to U.S. corporations than waiting for a complete overhaul of the corporate tax system, is to revive Section 965 of the Internal Revenue Code to provide another temporary tax holiday for repatriated corporate earnings. Enacted as part of the American Jobs Creation Act in 2004,[2] Section 965 permitted U.S. corporations with foreign subsidiaries to bring their overseas profits back into the United States at a reduced tax rate.[3] Despite the introduction of several bills,[4] no action was taken to enact a new repatriation tax holiday by the end of 2011. Lawmakers in both political parties stated that any action on a repatriation tax holiday in 2011 might adversely affect legislative interest and momentum toward enacting broader corporate tax reform, such as the permanent reduction of the corporate income tax rate or, more radically, transitioning the United States from a worldwide to a territorial system of international taxation. [5]

Although Section 965 is a relatively obscure provision under the Internal Revenue Code, it touches upon much larger issues in international taxation that never seem to go away. Should the United States shift from its present international tax system, the worldwide taxation of corporate income (in theory) to a territorial system, where the only corporate income subject to the federal income tax would be income earned in the United States? Given the realities of economic globalization, including truly global labor and consumer markets (under which U.S. corporations have been operating for at least the past 40 years), why does the United States continue to use a worldwide international tax system when other industrialized nations favor a territorial tax system?[6]

Some proponents of broad corporate tax reform argue that Section 965, even if revived, would not go far enough to level the playing field for U.S. corporations competing in the global marketplace because it would not completely eliminate residual repatriation taxes on the foreign income of U.S.-based multinational corporations.[7] In addition, even if the United States adopted a territorial tax system, purportedly to increase the competitiveness of U.S. corporations, would this result in increased domestic investment, job creation, infrastructural expansion and economic revitalization? Or would the adoption of a territorial tax system provide further incentive for U.S.

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[1] Donald J. Marples and Jane G. Gravelle, CONG. RESEARCH SERVE, R40178, TAX CUTS ON REPATRIATION EARNINGS AS ECONOMIC STIMULUS: AN ECONOMIC ANALYSIS (May 27, 2011).

[2] IRC § 965; American Jobs Creation Act of 2004, Pub L No 108-357, § 271, 118 Stat 1418.

[3] "Repatriation Debate Fuels 'War of Studies'," Tax Notes Today, 2011 TNT 199-5 (October 14, 2011).

[4] See HR 937, HR 1036, HR 1834, HR 2862, HR 3460, S 727, S 1671, and S 1837, all introduced in the 112th Congress (2011-2012).

[5] "Repatriation Holiday Appears Unlikely This Session," 2011 TNT 236-1 (December 8, 2011).

[6] United States Congress, Joint Economic Committee. "Reforming the US Corporate Tax System to Increase Tax Competitiveness," Washington, DC: May 2005, p 3 [hereinafter referred to as "Reforming the U.S. Corporate Tax System"].

[7] Mihir A. Desai & James R. Hines, Jr., Old Rules and New Realities: Corporate Tax Policy in a Global Setting, 57 Nat'l Tax J 937 (2004) [hereinafter referred to as Old Rules and New Realities].

corporations to shift their income to foreign taxing jurisdictions, increasing economic investment and corporate expansion overseas?[8] This article briefly reviews proposals to reduce or exempt U.S. corporate foreign income from taxation by either reviving Section 965 or by adopting a territorial tax system, and discusses the implications for corporate tax reform.

§ 1.02 The United States Tax System as a Hybrid Worldwide System

The United States tax system is generally described as a worldwide system of taxation, which taxes the income of U.S. chartered corporations at a maximum tax rate of 35 percent regardless of where that income was earned.[9] However, it is acknowledged that the United States worldwide tax system is really a hybrid, since it permits U.S. corporations to defer indefinitely paying income tax on foreign earnings, generated by corporate-owned subsidiaries overseas, as long as those earnings are not repatriated to the United States.[10] As a result, many U.S. corporations decide to keep foreign income permanently invested abroad, given the unattractiveness of the 35 percent domestic corporate tax rate the foreign income is subject to once it is repatriated. Given the incentives for U.S. corporations to indefinitely defer repatriation of foreign income to the United States to avoid paying corporate income tax, the current international tax system effectively "locks out" corporate foreign income from use in domestic corporate reinvestment, job creation and expansion.[11]

In addition, economic globalization has driven U.S. corporate expansion worldwide. U.S. corporations minimize their labor and production costs by incorporating foreign subsidiaries and relocating their operations overseas. With concomitant advances in communications technology and the English language becoming a global *lingua franca* in the process, business competition is more international than ever, as seen by the rise in emerging economic, labor and consumer markets worldwide. In turn, increasing amounts of U.S. corporate aggregate income is foreign income generated by its subsidiaries.[12] As foreign economic markets become more sophisticated, U.S. corporations increasingly use foreign income to finance corporate expansion overseas, and not in the United States. The 35 percent tax rate on the repatriated income of a U.S. corporation, one of highest corporate tax rates worldwide, effectively provides an incentive for U.S. corporations to invest profits anywhere else in the world *except* in the United States.[13]

In light of these global economic realities, proponents of corporate tax reform argue that the federal tax code must be overhauled in order for U.S. companies remain competitive in the global marketplace. Some proponents of tax reform specifically argue that the United States should transition to a territorial system of international taxation, meaning that a U.S. corporation only pays the corporate income tax rate on its earnings realized in the United States, in order to increase the competitiveness of U.S. corporations with foreign business competitors who are not subject to high corporate tax rates under their own countries' international taxation systems.[14]

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[8] E. Kleinbard, "Throw Territorial Taxation From The Train," Tax Notes (February 5, 2007), pp 547-564 [hereinafter referred to as "Throw Territorial Taxation From The Train"]; see also, James R. Repetti, Will U.S. Investment Go Abroad in a Territorial Tax: A Critique of President's Advisory Panel on Tax Reform, 8 Fla Tax Rev 303 (2007).

[9] IRC § 11; see Matthew J. Mauntel, Stimulating The Stimulus: U.S. Controlled Subsidiaries and I.R.C. 965, 33 BC Int'l & Comp L Rev 107 (2010), retrieved January 3, 2012 at http://lawdigitalcommons.bc.edu/iclr/vol33/ii1/6.

[10] Reforming the U.S. Corporate Tax System, *supra* note 6, p 3; see also Lisa M. Nadal, Repatriation Gluttony – Was It Worth It? 119 Tax Notes 1128 (June 23, 2008) [hereinafter referred to as "Repatriation Gluttony"].

[11] Roy Clemons, Two Essays on the American Jobs Creation Act of 2004, Ph.D. dissertation, Texas A&M University, Department of Accounting (August 2008), p 37 [hereinafter referred to as "Two Essays"], retrieved January 3, 2012 at http://repository.tamu.edu/bitstream/handle/1969.1/ETD-TAMU-2852/CLEMONS-DISSERTATION.pdf?sequence=1

[12] Old Rules and New Realities, *supra* note 7, p 939.

[13] See G. Hufbauer and J. Kim, U.S. Taxation of Multi-National Corporations: What Makes Sense, What Doesn't, Policy Brief No. PB09-7 (March 2009), Peterson Institute for International Economics, retrieved January 3, 2012 at http://www.iie.com/publications/pb/pb09-7.pdf.

[14] Reforming the U.S. Corporate Tax System, *supra* note 6, p 4.

However, under a territorial system of taxation, the foreign income a U.S.-based multinational corporation would be exempt from taxation, beyond the reach of the Internal Revenue Service and greatly reducing corporate tax revenues. As a practical matter, the task of transitioning the United States tax system from a worldwide to a territorial system would be so monumental in scope that it seems unlikely to occur at all, regardless of the political climate under which such reform would be wrought. In light of such daunting reforms, proponents of corporate tax reform view tax holidays, such as the repatriation tax holiday under Section 965, as a more expedient form of tax legislation that can achieve at least some of the same goals as might a complete overhaul of the corporate tax system.[15]

§ 1.03 The Repatriation Tax Holiday under Section 965 of the Internal Revenue Code

Tax holidays, defined briefly, are the temporary reduction or suspension of a tax that normally would have to be paid by taxpayers. In an effort to motivate U.S. corporations with overseas subsidiaries to bring their "locked-out" overseas earnings back to the United States without having to pay the 35 percent tax rate on foreign income, Congress instituted a temporary tax holiday on repatriated earnings by enacting Section 965 of the Internal Revenue Code.[16] Section 965 was intended to encourage domestic job creation and economic investment by permitting a U.S. corporation to repatriate up to 85 percent in foreign income tax-free, at an effective tax rate of only 5.25 percent, up to a maximum of either: (1) $500 million; (2) the amount permanently invested outside the United States; or (3) failing sufficient documentation of amounts permanently invested outside the United States, the amount of tax liability attributable to earnings reinvested outside the United States, divided by 0.35, whichever amount is largest.[17] This repatriation tax holiday was only in effect for tax years 2004 and 2005, and a U.S. corporation could only elect to claim the dividends received deduction (DRD) on a one-time basis.[18]

A U.S. corporation wanting to claim the DRD could only do so if certain criteria were met.[19] Among other requirements, a U.S. corporation had to use the DRD to fund a domestic reinvestment plan (DRIP), approved by a corporate executive decision-maker and a corporate management or executive committee, to fund domestic hiring or training, infrastructure or other capital investment, research and development, or financial stabilization.[20] Specifically, DRD funds could not be used to fund executive compensation or to pay out shareholder dividends.[21] The legislative intent behind Section 965 was for repatriating corporations to use DRD funds for domestic job creation and investment.

Unfortunately, several empirical studies evaluating the effectiveness of Section 965 have concluded that repatriating U.S. corporations overwhelmingly failed to use the DRD to stimulate job growth or the domestic economy.[22] These reports conclude that, although Section 965 was wildly

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[15] Repatriation Gluttony, *supra* note 10, p 1128.
[16] IRC § 965.
[17] IRC § 965(b)(1)(A)-(C). Some argue that the effective tax rate on repatriated funds was even lower than that. See Edward D. Kleinbard and Patrick Driessen, "A Revenue Estimate Case Study: The Repatriation Holiday Revisited," 120 Tax Notes 191 (September 22, 2008).
[18] IRC § 965.
[19] For a brief review of the requirements to take the DRD, see Repatriation Gluttony, *supra* note 10, p 1128.
[20] IRC § 965 (b)(4)(ii).
[21] IRC § 965 (b)(4)(iii) & (c)(3).
[22] See, eg, Two Essays, *supra* note 11, p 5; see United States Congress, Majority Staff Report, United States Senate Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, Repatriating Offshore Funds: 2004 Tax Windfall for Select Multinationals. Washington DC: October, 2011 [hereinafter referred to as "Repatriating Offshore Funds"].

successful in encouraging U.S. corporations to repatriate offshore profits, this did not result in an appreciable increase in investment activities or job creation in the United States. Instead, there appeared to be a spike in stock repurchases, shareholder payouts and executive pay, all prohibited uses of DRD funds under Section 965, during or shortly after the time period in which U.S. corporations claimed the DRD.[23] Some U.S. corporations claimed the DRD while simultaneously eliminating jobs in the United States.[24] Other studies show that since 2004, many U.S. corporations have strategically shifted corporate income to overseas tax havens in anticipation that another repatriation tax holiday will be enacted by Congress at some point in the near future.[25] If anything, Section 965 has unintentionally provided another disincentive for U.S. corporations to invest their profits domestically.

Tax commentators report that, since Section 965 did not include a tracing requirement or any way to measure whether the DRD funds contributed to a net increase in domestic investment, many U.S. corporations simply used the DRD to fund expenditures that were already included in the company budget. Since cash is fungible, the substitution of DRD funds for "ordinary" corporate funds effectively freed up monies which could then be used to fund stock repurchases, executive compensation and other uses that were prohibited for DRD funds under Section 965. By simply moving money around, many U.S. corporations followed the letter, but not the spirit, of Section 965.[26] As a result, many tax experts conclude that Section 965 only served to provide a giant tax break for U.S.-based multinational corporations, contrary to the legislative intent for enacting Section 965.[27] As tax policy, most tax experts agree that Section 965 was a spectacular failure, at least as far as the American public is concerned.[28] Only a few tax commentators have focused on the fact that the IRS was also a winner under Section 965: had Section 965 not been enacted, U.S. corporations would have had no motivation to repatriate offshore profits that resulted in $16.4 billion in revenue to the Internal Revenue Service.[29]

§ 1.04 Lessons Learned and the 2011 Bills Reviving Section 965

Despite the failure of Section 965 to spur domestic economic investment and job creation, there are lawmakers who support the revival of an improved Section 965 as part of broader corporate tax reform. Pinson and Shanley propose the following suggestions on how Section 965 could be strengthened to ensure that U.S. corporations actually use repatriated foreign earnings for domestic investment: (1) adding a tracing requirement for repatriated funds; (2) adding a definite time frame for completing domestic reinvestment of the DRD under the DRIP, and a "before and after" test to measure whether any net increase in domestic investment occurred; (3) adopting a two-tier tax holiday whereby a corporation can elect to repatriate foreign income at either of two tax rates.[30] The first tax rate, a moderately reduced corporate tax rate on repatriated earnings, would be applied if the U.S. corporation wants no restrictions on its use of repatriated funds. The second tax rate, a much more favorable corporate tax rate on repatriated earnings, would be applied as long as the U.S. corporation can show that it complied with the proposed rules and reinvested the funds domestically.

[23] Two Essays, *supra* note 11, p 5 ("The significant increase in stock repurchases suggests that at least some portion of the repatriations were indirectly funneled to prohibited expenditures.").
[24] Repatriation Gluttony, *supra* note 10, p 1128.
[25] M. Mendel Pinson and Melanie Shanley, "Effects of 2004 Int'l Tax Holiday, Recommendations Going Forward," 132 Tax Notes 845 (August 22, 2011) [hereinafter referred to as "Effects of 2004 Int'l Tax Holiday"]; Rodney P. Mock and Andreas Simon, "Permanently Reinvested Earnings: Priceless," 121 Tax Notes 835 (November 17, 2008).
[26] Stimulating The Stimulus, *supra* note 9, p 117-118.
[27] Repatriation Gluttony, *supra* note 10, p 1128.
[28] Two Essays, *supra* note 11, pp 33-34; Repatriating Offshore Funds, *supra* note 23, p 5; But see, Joann M. Weiner, Bring Back the Repatriation Tax Holiday, 122 Tax Notes 573 (February 2, 2009).
[29] Stimulating The Stimulus, *supra* note 9, p 119.
[30] Effects of 2004 Int'l Tax Holiday, *supra* note 25, p 851.

Additionally, future profits generated from the domestic reinvestment of repatriated funds would be subject to a lower corporate income tax rate than the current rate of 35 percent.[31]

Although none of the 2011 bills went that far, each of the bills proposed to amend Section 965 to ensure that the revived Section 965 would achieve what the current version of Section 965 did not: the actual reinvestment of repatriated income domestically to spur economic growth and job creation in the United States. The Freedom to Invest Act, or the Brady-Matheson Bill, was introduced on May 11, 2011.[32] A bipartisan bill, the Brady-Matheson bill would permit a U.S. corporation to claim a temporary DRD for repatriated funds at an effective corporate tax rate of 5.25 percent for either tax year 2011 or 2012. U.S corporations who claim the DRD must maintain, but not necessarily increase, employment levels before and after taking the DRD. "Failure to keep employment levels" for at least two years after taking the DRD would result in the corporation's having to declare $25,000 in income multiplied by the number of employees below the employment level.[33] Another similarly bipartisan bill, the Foreign Earnings Reinvestment Act, or the Hagan-McCain bill, was introduced on October 6, 2011.[34] The Hagan-McCain bill would temporarily permit U.S. corporations to repatriate offshore profits at an effective tax rate of 8.75 percent. If the electing corporation expands its domestic payroll by 10 percent in tax year 2012, the effective corporate tax rate on repatriated funds drops to 5.25 percent. The Hagan-McCain bill also requires U.S. corporations to maintain employment levels for at least two years after taking the DRD. If a U.S. corporation claims the DRD but then sheds domestic jobs, the corporation is penalized by having to declare as income $75,000 for every full-time position that is eliminated after having claimed the DRD.[35]

An additional bill, the American Jobs First Act of 2011, would permit U.S. companies to repatriate foreign earnings at a temporarily reduced tax rate of 25 percent, which would be lowered to 5.25 percent if the company increases its payroll by 14 percent.[36] A fourth bill, the Rebuilding America Act, proposes permanently reducing the corporate tax rate on repatriated earnings to 5 percent.[37] Four additional bills introduced in 2011 proposed overall reductions of the corporate tax rate and/or reviving Section 965 to provide either a temporary or permanent tax rate reduction on repatriated earnings. These bills vary regarding the extent to which U.S. corporations would be restricted in using repatriated funds in order to qualify for the lowest reduced tax rate.[38]

§ 1.05 Implications for Tax Reform, from a Worldwide (Hybrid) System to a Territorial System

Given the hybrid model of international taxation currently in place, ineffective anti-deferral rules, and bipartisan support for corporate tax repatriation holidays in Washington, Nadal states that it may be more intellectually honest for the United States to transition over to a territorial system of taxation on corporate earnings.[39] However, not all U.S. corporations necessarily win under a territorial tax system, given that the adoption of a territorial tax system also usually means the

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[31] *Id.*
[32] HR 1834, 112th Cong. (2011-2012).
[33] HR 1834, § 2.
[34] S 1671, 112th Cong (2011-2012).
[35] Hagan & McCain Introduce Bipartisan Foreign Earnings Reinvestment Act (October 6, 2011), Press Release, retrieved January 3, 2012 at http://hagan.senate.gov/?p=press_release&id=1465.
[36] HR 3640, 112th Cong (2011-2012).
[37] S 1837, 112th Cong. (2011-2012).
[38] HR 937 (Rising Tides Act), HR 1036 (The Jobs Creation and Innovation Investment Act of 2011), HR 2862 (Putting America Back to Work Act of 2011), S 727 (Bipartisan Tax Fairness and Simplification Act), all of the 112th Congress (2011-2012).
[39] Repatriation Gluttony, *supra* note 10, p 1128.

phasing out of foreign tax credits, deductions for expenditures related to foreign business activities, and other measures intended to offset a U.S. corporation's tax liability on foreign income under a worldwide system of international taxation.[40]

Although adopting a territorial tax system would eliminate taxation on repatriated funds, some tax commentators argue that a territorial tax system is likely to encourage a drastic increase in transfer pricing abuses, where corporations chartered in high-tax jurisdictions reduce their tax liabilities by shifting profits from the high-tax jurisdiction (e.g., the United States) to foreign subsidiaries located in low-tax jurisdictions.[41] Given the relative ease with which intangible corporate assets can be exported from a high-tax jurisdiction to a low-tax jurisdiction (such as pharmaceutical patents, for example), the adoption of a territorial tax system could only further exacerbate this problem, resulting in lost tax revenues domestically.[42] If the United States adopted a territorial tax system without a concomitant reduction in the corporate tax rate, transfer pricing abuses would likely accelerate, with U.S. corporations shifting as much domestic corporate income as possible to their foreign subsidiaries in low-tax jurisdictions to exempt it from taxation.

One study concluded that making significant modifications to the Internal Revenue Code (specifically to Subpart F, the expense allocation rules, and the foreign tax credit rules) would be an easier way to effect corporate tax reform without having to make the radical shift to a territorial tax system.[43] Additional studies are needed to determine whether corporate tax reform can be achieved in the United States without having to abandon its worldwide tax system in favor of a territorial tax system.

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[40] Martin B. Tittle, "Three Problems Associated With Territorial Taxation," 50 Tax Notes International 1103 (June 30, 2008), retrieved January 3, 2012 at http://www.martintittle.com/publications/Tittle_territorial.pdf.

[41] Throw Territorial Taxation From The Train, *supra* note 8, p 552.

[42] David L. Brumbaugh, CONG. RESEARCH SERVE, PL31444, FIRMS THAT INCORPORATE ABROAD FOR TAX PURPOSES: CORPORATE "INVERSIONS" AND EXPATRIATION 2 (Jan 26, 2007); see also, eg, Jesse Drucker, U.S. Companies Dodge $60 Billion in Taxes With Global Odyssey (May 13, 2010), retrieved January 3, 2012 at http://www.bloomberg.com/news/2010-05-13/american-companies-dodge-60-billion-in-taxes-even-tea-party-would-condemn.html;.

[43] Nat'l Foreign Trade Council, Territorial Study Group, Territorial Tax Study Report (June 11, 2002), retrieved January 3, 2012 at http://www.nftc.org/default/Tax%20Policy/06_13_02_Territorial_Tax_Study_Report.pdf.pdf; see also Paul R. McDaniel, Territorial vs Worldwide International Tax Systems: Which is Better for the U.S.? 8 Fla Tax Rev 283 (2007); Jane G. Gravelle, International Corporate Tax Reform: Issues and Proposals, 9 Fla Tax Rev 469 (2009).

Joel S. Newman on Research and Development: Did the Tax Laws Torpedo the Paxton Phoenix Steam Car?

By Joel S. Newman, J.D.*

§ 2.01 Introduction

Robert Paxton McCulloch inherited a fortune, and added to it with his chainsaw company. Then he spent it. He almost built a steam-powered automobile in the late 1940s and early 1950s. One might think that anyone crazy enough to do that would have been crazy enough to buy the Brooklyn Bridge. He didn't. He bought the London Bridge instead, and moved it to Arizona.

The steam-car project was abandoned in 1954.[1] His foreman claims that the abandonment was caused by unfavorable tax laws.[2] Was it?

This article will describe the development of McCulloch's steam-powered automobile—the Paxton Phoenix—and what happened to it. It will then consider the question, "Who shot the Phoenix?" Was it the tax laws, or was it something else? Finally, it will consider whether or not things have improved, at all.

§ 2.02 The Steam-Powered Automobile: The Early Years

[1] The Stanley Twins

Mention steam-powered automobiles, and most people think of the Stanley Steamer. The Stanley twins, Freelan and Francis, began building steam cars in 1897. By the time the Stanley Motor Carriage Company ceased production in 1924, they had built some 11,000 of them. The Stanley/Locomobile was the most popular automobile in the United States from 1900 to 1904. It was simple, with 37 moving parts, in contrast to the thousands of parts of its gas-driven competitors. It was also reliable, and powerful.

Perhaps its biggest competitive advantage was the ease of starting. The early gas automobiles had to be started with a crank. Sometimes, balky cranks led to broken arms.[3] As to the Stanley Steamers, it may have taken as much as twenty minutes for the water to heat, but otherwise, starting was effortless, and crankless.

Two developments, however, led to the decline in popularity of the steamer. The first was price. By 1914, with the development of mass production, Henry Ford was producing twice as many automobiles in a day as Stanley was producing in a year. As a result, a Model T cost only one fourth the price of a Stanley.

Second was the invention of the electric starter, which first appeared on the Cadillac in 1912. With the disappearance of the cranks, the gas-powered cars became as easy to start as the steamers. Now, the

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[1] John Bond, "Is Steam Coming Back? The true story of the Paxton Phoenix," Road and Track (April 1957) [hereinafter referred to as "Bond"].

[2] Paul Stenquist, "Dreaming of Steam, but Running on Gas," NY Times, May 15, 2011, at Sports 10 [hereinafter referred to as "Stenquist"]; telephone interview with Jerry Williamson, foreman on the Paxton project, May 23, 2011 [hereinafter referred to as "interview"].

[3] Jay Leno, "Jay Leno and His Doble Steam Cars," Popular Mechanics, retrieved August 2, 2011 at http://www.popularmechanics.com/cars/jay-leno-and-his-doble-steam-cars) [hereinafter referred to as "Leno"].

instantaneous starting of the gas cars became far preferable to the twenty-minute wait required for the steam cars. The Stanley never recovered.[4]

[2] The Doble Brothers

The four Doble brothers built their first steam car in their parents' basement, while still in high school, in the years 1906 to 1909. Their "Model B" included a water-condensing device, which gave the vehicle a range of 1,500 miles, in contrast to the 100-mile range of the contemporary Stanleys.[5] In 1915, with $200,000, Abner Doble founded the General Engineering Company, and started work on the Doble Model C.

The Model C featured two more improvements. The first was a key-based ignition system, so that the operator did not have to ignite the boiler by hand. However, the second innovation—the flash boiler system—was far more significant. Kerosene was atomized and ignited with a spark plug. Then, the water was rapidly heated inside coiled steel tubes.[6] As a result, the twenty minutes previously required to get the boiler up to steam was reduced to ninety seconds.[7] Furthermore, the Doble was powerful, quiet, and fast. In 1914, the earlier Doble Model B accelerated from zero to sixty in fifteen seconds, while a contemporary Model T took forty seconds to reach its top speed of 40-50 miles per hour.[8]

The Doble brothers, however, were great engineers, not great businessmen. Technical glitches and questionable stock sales sullied the reputation of the company, but what really did it in was the price. The Doble cost $18,000 in 1924,[9] and later $20,000, at a time when the Model T Ford cost $260.[10] The company went out of business in 1931.[11]

Perhaps his company went under, but Abner Doble's personal reputation as an expert in steam technology endured.[12] For the rest of his life, he made his living as a consultant on steam power. One of those who consulted him was Robert Paxton McCulloch.

§ 2.03 McCulloch

Robert Paxton McCulloch is best known for his chain saw. His breakthrough product came in 1949, when he developed a chain saw which could be operated by one person—not two.[13] In that same year, he initiated the steam car project, through his Paxton Engineering Division.[14] He hired Abner Doble to help with the steam technology, Roscoe Hoffmann to help with the chassis, and famed industrial designer Brooks Stevens to design the body.[15]

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4 The Stanley Steamer, Why the Fascination? http://www.stanleymotorcarriage.com/GeneralTechnical/GeneralInfo.htm, retrieved on July 25, 2011.

5 Alan Bellows, The Last Great Steam Car, retrieved July 25, 2011 at http://www.damninteresting.com/the-last-great-steam-car [hereinafter referred to as "Bellows"].

6 The Doble patented atomized burner is still being used in home oil burners to this day. Stanley Steamer, Why the Fascination?, retrieved August 2, 2011 at http://www.stanleymotorcarriage.com/GeneralTechnical/GeneralInfo.htm.

7 For a more technical description, see Abner Doble, Steam Motor-Vehicles (presented on October 20, 1916), retrieved July 25, 2011 at http://www.catskillarchive.com/rrextra/automo.Html.

8 Alan Bellows, *supra* note 5. For pictures and videos of Doble cars, see The Steam Car Club of Great Britain website, at http://www.steamcar.net/dobles.html. Jay Leno claims that he drove his Doble at 85 m.p.h., and that the previous owner, Harold Hughes, had it at 132.5 m.p.h. Leno, *supra* note 3.

Howard Hughes invested half a million dollars in the late 1920s in the development of a steam car. When he learned that the resulting prototype would probably scald the driver to death if it were hit broadside, he ordered it dismantled. Noah Dietrich, Howard-The Amazing Mr. Hughes (1972) Chapter 7, "The Hughes Steamer."

9 Bellows, *supra* note 5.

10 Leno, *supra* note 3.

11 Bellows, *supra* note 5.

12 "What Shakespeare was to literature, Abner Doble was to steam vehicles." Auto Editors of Consumer Guide, 1953 Paxton Convertible Coupe, retrieved July 25, 2011 at http://auto.howstuffworks.com/1953-paxton-phoenix-convertible-coupe.htm/printable.

13 The Story of McCulloch, retrieved July 25, 2011 at http://www.mcculloch.biz/int/discover-mcculloch/history/ .

14 Interview, *supra* note 2. The Bond article states that the Paxton Division was formed in 1950. Bond, *supra* note 1.

15 Stenquist, *supra* note 2.

The steam engine would use three high pressure cylinders and three low pressure cylinders, and, of course, a quick flash boiler developed by the Dobles. The engine was tested on a dynamometer and on a Ford chassis,[16] but it was never installed in what became the Paxton Phoenix.

The only prototype ever built was the 1953 Paxton Phoenix Convertible Coupe. It was, and is, a truly beautiful automobile, with many advanced design features, reminiscent of airplane technology, and of the groundbreaking Studebakers that Brook Stevens designed later.[17] A Porsche 356 engine and transaxle were installed in the vehicle, "…so the chassis could be tested as steam engine development continued."[18] The entire project, however, was abandoned in 1954, before the steam engine was ever installed. Yet, the prototype survives, and is still a popular attraction at collectible car shows.

Why was the project abandoned? Jerry Williamson, the foreman of the Paxton project, and the "last surviving member of the Phoenix team,"[19] explained: "[t]he death of the car was purely economical. Tax laws had changed, eliminating some write-offs for research and development."[20]

However, others felt differently. A writer at Road and Track Magazine asked McCulloch himself why the project was dropped:

> …he summed it up neatly. In our words, it boils down to a problem of engineering man-power. As everyone knows, there is a tremendous shortage of engineers in this country, and the car program was taking trained technicians away from multitudinous McCulloch projects in other fields—fields which, for numerous good reasons, the company feels will be more profitable (and perhaps less risky) than the automobile manufacturing business.[21]

So, the question remains. Did the tax laws kill the Paxton Phoenix? To answer that question, one must look at the taxation of research and development ("R&D") in the years just before the 1954 Code.

§ 2.04 Taxation of Research and Development before the 1954 Code

The pre-1954 commentary reads as if everyone was using the same script:

> At present, the tax law and the tax practice in this area come very close to being in direct conflict with each other. The resulting uncertainty in the minds of taxpayers acts as a definite deterrent to research.[22]

Uncertainties as to the attitude of the Bureau of Internal Revenue regarding the deduction of research and development expenses are a deterrent to research expenditure.[23] We have it, on acceptable authority, that uncertainty over the attitude of the Bureau of Internal Revenue towards the deduction of research and development costs is a deterrent to industrial research.[24]

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[16] *Id*. For technical notes on the Paxton Phoenix, see McCulloch Steam Car: Random Notes. http://www.oac.cdlib.org/ark:/13030/kt3s20178z/?order=2&brand=oac4.

[17] Stevens designed the Studebaker Grand Turismo Hawk. He also designed the Oscar Mayer Weinermobile. So nobody's perfect. Stenquist, *supra* note 2.

[18] *Id.*

[19] Stenquist, *supra* note 2.

[20] *Id.* Mr. Williamson made essentially the same points to me in our telephone interview. He did say, however, that Mr. McCulloch came to realize that to enter into the automobile business required billions of investment, and that he was spread way too thin. Interview, *supra* note 2.

[21] Bond, *supra* note 1. For a similar take, *see* Paxton Phoenix Convertible, retrieved on August 2, 2011 at http://auto.howstuffworks.com/1953-paxton-phoenix-convertible-coupe.htm. Another terse explanation was "problems with the steam engine." Stenquist, *supra* note 2 (quoting from March 2009 Classic and Sports Car Magazine).

[22] J. Keith Butters, Taxation and New Product Development, Harv Bus Rev 452 (1945).

[23] Vannevar Bush, Science—The Endless Frontier, 48 Transactions, Kansas Academy of Science 231, 244 (1945).

[24] Jack Miller, Research and Development Costs, 7th Ann NYU Inst on Tax'n 134 (1949).

"Uncertainty" is a "deterrent." They all said it.[25] The big uncertainty was whether research and development expenditures could be deducted currently, or had to be capitalized. If the expenditures were capitalized, they would be added to the basis of the business asset. Then, they would be deducted later, either as the basis was amortized over time, or perhaps only upon the final sale or abandonment of the project.

The regulations suggested capitalization, but the case law and practice suggested that current deductions were sometimes possible. In fact, one commentator suggested that R&D always be deducted currently, just in case.[26]

To some extent, the cases turned upon the success of the enterprise. Generally, successful R&D expenses had to be capitalized;[27] while failed R&D expenses were currently deductible. *Strong v. Commissioner*,[28] for example, involved a centrifugal threshing machine. None of the $4,461.77 expended by the taxpayer in 1923 developed anything that was "…of subsequent use to him or improved the machine in any way.[29] Since the amounts expended "…added no capital improvement to the machine, certainly not of a lasting nature, which could in anywise be considered a capital investment,"[30] the expenditure was held to be currently deductible. Of course, even if the test had been relatively cut and dried—unsuccessful R&D is currently deductible, successful R&D must be capitalized—that test would not have been of much help. In the year when the expenses are incurred and current deductions are considered, one does not yet know whether the R&D will be successful.

But the test was not so cut and dried, after all. Not all failed R&D led to current deduction treatment. In *Dresser Manufacturing Co. v. Commissioner*,[31] the taxpayer's efforts with respect to a gas compressor engine gave rise to no asset of any value. "They had merely 'learned a great many ways of not doing it and that was about all.'"[32] Yet, the $96,000 of R&D expenses had to be capitalized.[33]

If capitalization was the proper treatment, then there were two further difficulties. First, over what period of time could the expense be amortized? If a patent had been obtained, then it was relatively clear that

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[25] See also, Leon Rice, Research and Development Costs, 25 Taxes 41(1947) (stating that "[t]he time is overdue for clarification" (at 41) and that "[t]he existing rules are fraught with such uncertainties and impracticalities" (at 42)). When Congress finally got around to improving things, it, too, characterized the problem similarly:
Uncertainty whether particular expenditure is deductible or must be capitalized, particularly where there is no regular research budget. Unusual research expenses must be capitalized and written off in later years. Discourages research.
Reports of the Special Tax Study Committee to the Committee on Ways and Means, (Nov 4, 1947) at 105. See generally, Xuan-Thao Nguyen and Jeffrey A. Maine, The History of Intellectual Property Taxation: Promoting Innovation and Other Intellectual Property Goals? 64 SMU L Rev 101 (2011).
[26] Leon Rice, Research and Development Costs, 25 Taxes 41 (1947). In Appeal of Gilliam Mfg Co, 1 BTA 967 (1925), and Appeal of Goodell –Pratt. Co., 3 BTA 30 (1925), the taxpayer currently deducted R&D expenses, but later argued that the expenses should have been capitalized. The Board of Tax Appeals agreed both times. In Pittsburgh Screw and Bolt Corp v Comm'r, 2 TCM 747 (1943), the taxpayer again claimed that the current R&D deductions it had taken were improper, and should have been capitalized. This time, the taxpayer made "…an equitable gesture and undertakes, irrespective of the bar of any statute of limitations, to pay any additional income taxes for prior years, together with interest thereon, resulting from the disallowance in such years of any such items as may be restored to cost in computing its capital gain in 1939 upon sale of its Propeller Division." The Tax Court seemed to think that current deduction vs. capitalization was a close case, that the taxpayer had made its choice already, and was stuck with it.
[27] Claude Neon Lights, Inc v Comm'r, 35 BTA 424 (1937); Hazeltine Corp v Comm'r, 32 BTA 110 (1935); Forest Products Chemical Co v Comm'r, 27 BTA 638 (1933); Appeal of Gilliam Mfg Co, 1 BTA 967 (1925); Appeal of Goodell –Pratt Co, 3 BTA 30 (1925); Appeal of The Beaumont Co, 3 BTA 822 (1926).
[28] 14 BTA 902 (1928).
[29] *Id*. at 903.
[30] *Id*. at 904.
[31] 40 BTA 341 (1939).
[32] *Id*. at 345.
[33] See also, Hart-Bartlett-Sturtevant Grain Co v Comm'r, 182 F2d 153 (8th Cir 1950). The Tax Court noted, "It is obvious … that it was at least within the contemplation of petitioner's officers that research in regard to chemicals from grain might develop something of permanent value to petitioner." 12 TC 760, 767 (1949). Apparently, the Eighth Circuit agreed, despite the taxpayer's characterization of the research as merely "…a long range shot in the dark." 182 F2d 153, 156.

the then 17-year life of the patent was the amortization period,[34] though some argued for a shorter obsolescence.[35] But what if no patent had been obtained?

Second, when could an abandonment loss be taken? In *Hart-Bartlett-Sturtevant Grain Co. v. Comm'r*,[36] the taxpayer contracted with the Midwest Research Institute to research the "latent industrial and agricultural potentialities of the Middlewest area with the object of improving agricultural economy."[37] "Nothing of a commercial value or of patentable nature" was developed by April 30, 1946, the end of the 1946 taxable year.[38] Accordingly, the biological research was dropped on November 1, and the researchers were transferred to other projects. The court held that the expenses had to be capitalized. Further, it held that the project could not have been deemed abandoned in Tax Year 1946, since the taxpayer continued to incur expenses after April 30. "How the expenditures should be treated for tax purposes during the year in which the experiments were finally abandoned," the Eighth Circuit noted, "was not before the Tax Court and is not before us."[39] Clearly, the Eighth Circuit opinion was not terribly helpful to tax planners on the timing question.[40]

The outlines of the argument are now clear. Robert P. McCulloch, through his Paxton Division, incurred substantial expenses in the development of a steam-powered automobile in the years from 1949 to 1954. It was an exceedingly risky venture – he had no idea whether or not he would succeed. Accordingly, he did not know whether the expenses were properly currently deductible, or whether they had to be capitalized. Moreover, if they were capitalized, the amortization period was uncertain, and, in the event of a total failure, so was the determination of the year of abandonment.

With all of these uncertainties of the tax laws operating to deter R&D ventures such as McCulloch's, no wonder that his risky, expensive project was abandoned. What a pity that the venture was abandoned in 1954, just before Congress finally rode to the rescue with the enactment of Internal Revenue Code Section 174. With that new section, current deductibility would have been assured,[41] and, if the taxpayer had chosen capitalization, the amortization period would have been set.[42] Things would have been even better with the later Section 41 Credit for Increasing Research Activities, if only we knew how it worked, and how long it would last.[43]

No doubt, the uncertainties of the tax laws did not make the development of the Paxton Phoenix steam car any easier, but that doesn't mean that they killed it. To get a better idea of whether the tax laws are in fact to blame, other possible culprits must be considered. In that regard, it is helpful to know what happened to McCulloch's steam car project after he abandoned it.

We already know what happened to the car itself. With luck, you can still see it. In addition, the best, most profitable technology from Paxton Engineering involved superchargers. Paxton Engineering, with

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[34] Claude Neon Lights, Inc v Comm'r, 35 BTA 424 (1937).
[35] Hazeltine Corp v Comm'r, 32 BTA 110 (1935). Taxpayer's arguments that patents in the fast-developing radio industry became obsolescent in less than 17 years were rejected.
[36] 182 F2d 153 (8th Cir 1950).
[37] *Id*. at 154.
[38] *Id* at 155.
[39] *Id*. at 157.
[40] Similarly, in Dresser Mfg Co v Comm'r, 40 BTA 341 (1939), the Board of Tax Appeals required that unsuccessful R&D expenses be capitalized, not currently deductible. It noted, "We express no opinion as to the year in which the expenditures so capitalized would become deductible." *Id*. at 343. Yet, later in the same opinion, the Board held that the efforts with respect to Engine No. 1 were abandoned in 1933, and that those as to Engine No. 2 were abandoned in 1934, and that losses were properly charged off in those respective years.
[41] IRC § 174(a).
[42] IRC § 174(b)(1).
[43] For a discussion of the current situation, see § 2.06, *infra.*

the supercharger technology, was sold to Andy Granatelli, who ultimately resold it to Studebaker.[44] It is now on its own, as Paxton Automotive.[45] Finally, the steam technology ended up with William Powell Lear.

§ 2.05 Post McCulloch: William Powell Lear

William Powell Lear was a brilliant and successful tinkerer and businessman. He was a pioneer in the development of automobile radios, airplane radios, and automatic pilots. Later on, he became famous again, for the Lear Jet.[46]

Lear liked to go to the casinos. In the late 1960's, when he lived in Reno, he especially liked Harrah's Club, which featured a collection of more than 1,000 meticulously restored antique automobiles.[47] Bill Lear and Bill Harrah became friends. Sometimes, Harrah would let Lear drive his Doble Steamer around the casino parking lot.

Then, in 1968, two twins from Pennsylvania, Calvin and Charles Williams, built a steam car and drove it to Washington, D.C.[48] They gave rides around the capital to many politicians, and generated a fair amount of publicity. Lear heard about it, and was intrigued. As it happened, he had just sold his interest in Lear Jet, and needed a new project. He set up a meeting with the Williams twins,[49] and ultimately decided to risk $1 million on research and $9 million on tooling for his new steam engines. "I want to be the man who eradicated air pollution," Lear said. "Wouldn't that be something?"[50]

Lear knew that in 1906 a Stanley Steamer Rocket, clocked at 127.6 miles per hour, had beaten a Ford Model K in a thirty-mile touring race. Lear figured that, if the Stanley twins had done it then, he could do it now. What better marketing coup could there be for his new steam-powered technology than to beat all the gas-powered racers in the Indianapolis 500? Lear set up shop in Stead, Nevada, and announced that he would build a steam-powered race car that would win the Indy 500.[51] Some two hundred orders came in for the new steam car, many with initial deposits. Lear hired 133 engineers and craftsmen, and set to work.[52]

Lear showed off the race car body at the International Auto Show in New York in 1969. Then, he installed his Delta II steam engine (presumably an improvement on the Delta I) in the body. It blew up, and it took $4 million of Lear's money with it.[53]

Lear kept looking for a liquid other than water that could generate the steam. He claimed that he found one, and called it Learium. He was lying.[54]

If he had to use water, then he was on the horns of a dilemma. At normal temperatures, the vapor generator and condenser would be too large for automobile use. If, on the other hand, the water was heated to a very high temperature, then he could use smaller vapor generators. However, the high temperatures would

[44] Andy Granatelli, Former CEO & President (Retired) STP Corporation, 2003 Recipient, Ellis Island Medals of Honor, retrieved August 2, 2011 at http://neco.org/awards/recipients/agranatelli.html.
[45] http://www.paxtonauto.com/article.php?id=3, retrieved August 2, 2011.
[46] Richard Rashke, Stormy Genius: The Life of Aviation's Maverick, Bill Lear (Boston, 1985) [hereinafter "Rashke"]; L.E. Leipold, William Powell Lear, Creative Designer and Inventor (Minneapolis 1967).
[47] See Harrah's Club v US, 661 F2d 203 (Ct Cl 1981) for the taxpayer's failed attempt to depreciate his collection.
[48] Steam Engine Car Awaits Demand, Industrial Research Magazine, Sept. 1967, reprinted in Steam Automobile Magazine, http://www.steamautomobile.com/archivepdf/SAv9n3.CV01.pdf.
[49] Setting up the meeting was difficult; the Williams twins were going bankrupt at the time, and did not have a telephone. Rashke, *supra* note 46, 303.
[50] *Id*.
[51] *Id* at 305; Michael Lamm, Bill Lear's Steam Car, 131 Popular Mechanics No. 4, 128 (1969) (hereinafter referred to as "Lamm"); Bob Ottum, "Let There Be Steam," Sports Illustrated, Feb 3, 1969.
[52] *Id*.
[53] *Id*. at 307.
[54] *Id*. Lear claimed that it was an aqueous solution with a soluble lubricant. Lamm, *supra* note 53.

cause metal fatigue—unless a more resistant metal could be found. He kept looking for the right liquid and the right metal, and found neither.[55]

Lear tried to convert a new Dodge Polaris engine into a steam engine, and sell it to the California Highway Patrol (CHP). However, none of the conversions made were practical. The CHP wasn't buying.[56]

Since the steam engines tended to be too bulky for a car, Lear decided to try buses. In 1970, the state of California obtained $2.3 million in federal grants from the Department of Transportation, and initiated the California Steam Bus Project. Three companies were to build experimental steam busses, to be tested in San Francisco, San Diego, and Los Angeles. Lear got the San Francisco contract.[57] General Motors gave Lear a 50-passenger bus and a Chevrolet Monte Carlo to play with, and, on February 11, 1972, Lear unveiled his Lear Steam Bus to reporters, in his Nevada facility. He gave the reporters rides for a while. Then, the driver feared that the boiler would explode, and the rides were terminated. The reporters were not terribly impressed.

In August, 1972, the Lear Vapor Turbine Powered Coach actually began service in San Francisco. It ran, though not without problems, for about two weeks. Lear had it driven up and down the city's steepest hills, and then from San Francisco to Reno. The California Steam Bus Project claimed that the bus was a success.[58]

Elated, Lear took the bus to Washington, and asked for a $30 million grant. He didn't get it, though he did get $900,000 from the Environmental Protection Agency.[59] Soon afterward, he installed a steam turbine engine in the Monte Carlo, and had it driven from Stead, Nevada to San Francisco, where it broke down.[60]

Lear had hoped that General Motors would support his efforts. Their tests, however, showed that his engine would only get 0.85 miles per gallon, on a simulated city bus route. General Motors declined to buy the rights to the engine or to Lear's research. Then, the federal Department of Transportation decided that it would no longer fund the California Steam Bus Project.[61] After GM, Fiat, and the federal government refused to support him any further, Lear finally pulled the plug on the steam project in 1975. He had spent some $17 million.[62]

In an earlier speech, Lear diagnosed his problems:

> A steam engine will never be mass-produced because it is too costly to build. It would be impossible to maintain, and for larger cars, the condenser would be too big to fit…You couldn't find a garage mechanic who could repair one…I told the federal government this, much to their chagrin. They thought the steam car was the answer to the pollution problem and I was the savior. I let them down.[63]

Lear's troubles, along with those of the Stanley twins, the Doble brothers, and the Williams twins, make it clear that the inherent technical problems of steam-powered automobiles were daunting. Of course, many technologies have daunting problems in their early development. Perhaps what was needed was just a bit more time and money, and just the right idea.

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[55] *Id.* at 307-308.
[56] *Id*. at 308; Lamm, *supra* note 53.
[57] Rashke, *supra* note 46, at 310.
[58] California Steam Bus Project Final Report, January 1973. http://libraryarchives.metro.net/DPGTL/scrtd/1973_california_steam_bus_project_final_report.pdf. For a video on the Project, showing the actual steam bus and William Lear, see http://www.celsius1414.com/2011/06/17/the-california-steam-bus-project-1972/ Both last retrieved on July 29, 2011.
[59] Later, the EPA would ask for its money back. They didn't get it. Rashke, *supra* note 46, at 321.
[60] *Id*. at 313.
[61] *Id.*
[62] *Id.* at 328-329.
[63] Speech given by William Lear to the Society of Automotive Engineers in Detroit, *Id*. at 308.

> It is true that the technology poses some difficult problems, but one cannot help but be curious how efficient a steam car might be with the benefit of modern materials and computers. With today's pressure to improve automotive performance and reduce emissions, it is not unthinkable that the steam car may rise again.[64]

Then again, perhaps what was needed was an investor with a different mindset. Robert McCulloch and William Lear were kindred souls. McCulloch was, after all, the man who bought the London Bridge.[65] Both McCulloch and Lear seemed to care more about the thrill of the chase than they did about the regular, boring returns on business success.

McCulloch's own foreman described Lear as "McCulloch plus."[66] As one Lear engineer put it:

There were six or seven things going on at once, all due Wednesday and undercapitalized. Lear was a guy with a new idea every day and we'd chase off in a different direction. He never exercised the discipline to see them through. He robbed yesterday to feed today. The steam project was consuming too much money and Lear saw the other projects as get-rich-quick schemes.[67]

Further, to quote his biographer:

> To Lear it was a game. He not only understood that his steam engine might never meet his projections, he also knew he might never even come up with a good steam engine. Basking in the hot media lights, however, he was having fun with his money, and if he had to eat crow someday, he would do it and move on to something else.[68]

Everyone who tried to develop a commercially viable steam car ultimately failed. The technical difficulties were huge, the money demands were enormous, and the competing technologies were powerful. The last two who tried—McCulloch and Lear—also had personalities which, perhaps, did not lend themselves to the long term, single-minded pursuit of such a difficult project.

Clearly, unfavorable tax laws were not the only problem hindering the development of the steam-powered automobile. Perhaps they were not even the most daunting problem. Remember that, by the time of Lear's ventures, Section 174 was in place, and the tax laws were considerably more favorable toward research and development than they were in McCulloch's time.[69] And yet, Lear still failed.

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[64] Bellows, *supra* note 5.

[65] McCulloch's London Bridge venture cannot be blamed for the abandonment of the steam car project. The Paxton Phoenix was abandoned in 1954, while McCulloch did not buy the Lake Havasu land until 1963, and did not buy the London Bridge until 1968. McCulloch bought the Bridge for almost 2 ½ million dollars, and moved it to Arizona. He also bought 11 Lockheed Electra airliners, formed McCulloch Airlines, and flew prospective investors to Lake Havasu for free. By 1978, there had been 2,702 free flights, with 137,000 prospective buyers. Lake Havasu City History. For a current brochure on the project, see http://www.londonbridgeresort.com. McCulloch was also involved with helicopters, aircraft accessories, and something called Pacific Optical. Bond. These far-flung, extravagant interests suggest that he, like Lear, might not have had the attention span required for a successful steam car.

[66] Interview, *supra* note 2.

[67] Rashke, *supra* note 46, at 307.

[68] *Id.* at 306.

[69] The marginal tax rates would also need to be considered. The top corporate rates during McCulloch's ventures (1949-1954) were 52%, while the top corporate rates during Lear's ventures (1968-1975) ultimately came down to 48%, not much difference. http://www.irs-soi/02corate.pdf. However, the top individual rates during McCulloch's ventures ranged from 82% to 92%, compared to a range of 70% to75% during Lear's venture. http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=213.

§ 2.06 The Tax Treatment of R&D Today

Perhaps the most ironic thing is that the same complaints about the state of the R&D tax laws pre-1954 still exist to this day. Things were complex and uncertain then; things are still complex and uncertain now. Just this year, the Joint Committee on Taxation wrote:

To the extent that research activities are responsive to the price of research activities, the research and experimentation tax credit should increase research activities beyond what they otherwise would be. However, the present-law research credit contains certain complexities and compliance costs that may obscure this effect.[70] Indeed.

Recent events do not exactly furnish grounds for optimism. It is, perhaps, bad enough that Section 41 is currently scheduled to expire on December 31, 2011.[71] However, one should also consider Treasury's attempts to draft regulations, and three recent pronouncements from the Internal Revenue Service (IRS).

[1] Treasury Attempts to Draft Regulations

On January 3, 2001, Treasury issued final regulations for research expenditures paid or incurred on or after January 3, 2001. These regulations imposed a "discovery test." However, the regulations addressing internal use software were to apply retroactively—to years beginning after December 31, 1985. Fair enough. But wait—there's more.

On December 26, 2001, Treasury promulgated Proposed Regulations under Section 41, to apply to taxable years ending on or after December 26, 2001. Treasury explained that the earlier 2001 Regulations "…did not fully address Congress' concerns regarding the importance of research activities to the U.S. economy." Thus, they proposed to change the "discovery test," to distinguish qualified, technological research from disqualified, non-technological research. They also proposed to change the internal use software provisions of the 2001 Regulations.

The Proposed Regulations were finalized on December 31, 2003. However, not all of the proposed changes were adopted in the finalized regulations. The "discovery test" was changed significantly and adopted, but the internal use software provisions were not. No new internal use software language was adopted; the relevant provision was left blank with the notation "Reserved."

In February of 2004, the IRS invited comments on the internal use software test. The Service noted:

> With respect to internal-use software for taxable years beginning after December 31, 1985, and until further guidance is published in the Federal Register, taxpayers may continue to rely upon all of the provisions relating to internal-use software in the 2001 proposed regulations. Alternatively, taxpayers may continue to rely upon all of the provisions relating to internal-use

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[70] Joint Committee on Taxation on Tax Incentives for Research, Experimentation and Innovation, JCX-45-11 (September, 2011). See also IRC §§ 59(e) and 280C(c)(3); Michael Mehanna, Trevor Ackerman, Michael Fishman, Charles Medallis, Adam Uttley, and Christine Kachinsky, "New M-3 Rules for R&D Costs Create Issues for Taxpayers," 132 Tax Notes 167 (July 11, 2011). See generally, Vsevolod Maksin, "Assets in Wonderland: The IRS's Inconsistent Policy on Software Costs," 21 Cardozo L Rev 959 (1999) ("The IRS has made a number of contradictory pronouncements regarding… software costs"); Michael D. Rashkin, "The Dysfunctional Research Credit Hampers Innovation," 131 Tax Notes 1057 (June 6, 2011); Meg Shreve, "Panelists Decry Administrative Hurdles to Research Credit Use," 131 Tax Notes 1336 (June 27, 2011); Alex Sadler and Jennifer Ray, "Navigating the Research Credit," 132 Tax Notes 1253 (Sept 19, 2011). For a helpful comparative law perspective, see the OECD's Testimony before the Senate Finance Committee on Sept. 20, 2011: "Tax Reform Options: Incentives for Innovation; The International Experience with R&D Tax Incentives." The UK has recently attempted to increase R&D through its tax laws with use of a "patent box." However, it is doubtful that such a scheme would work here, or there, for that matter. Martin A. Sullivan, "Time for a U.S. Patent Box?" 133 Tax Notes 1304 (Dec. 12, 2011).
Moreover, if the enterprise is transnational, then the complexity of the tax aspects of R&D takes a further, quantum leap. See IRC § 482, and consider the wonderful world of R&D cost-sharing agreements. Treas Reg § 1.482-7T.

[71] IRC § 41(h). The expiration date of the section has already been extended 14 times, sometimes retroactively.

> software in T.D. 8930 (the "2001 Final Regulations"). For example, taxpayers relying upon the internal-use software rules of T.D. 8930 must also apply the "discovery" test as set forth in T.D. 8930.

FedEx Corporation tried to make sense of these pronouncements, and, not surprisingly, ended up in court. The Court noted, "The 2003 Final Regulations do not provide for "internal use software," and the question is how to construe the absence of that provision. It concluded, "Here, the IRS impermissibly attempts to amend the 2003 Final Regulations with an announcement." FedEx's motion for summary judgment was granted.

One can see why they sued. Treasury comes up with a regulation in 2001, changes its mind less than a year later, comes out with new final regulations in 2003 without addressing the internal use software problem, and then, with an Announcement no less, tries to dictate how the whole bloody mess is to be interpreted.

[2] The IRS Directives

In 2007, the IRS Large Business & International Division (LB&I)[72] designated research and experimentation refund claims as a Tier I Issue. It noted that the high volume of refund claims filed, along with the compliance audit resources needed to deal with them, gave them a high level of strategic importance to LB&I. Accordingly, these claims would be subjected to closer scrutiny.[73]

In 2008, LB&I issued a new Audit Techniques Guide (ATG) for affirmative research and experimentation credit claims. The new ATG required examining agents to issue an information document request (IDR) with voluminous, detailed requirements. It provided a new checklist for examiners, and reminded examiners of the availability of the Section 6676(a) penalty for erroneous refund claims.

In 2009, LB&I issued a further Directive to supplement its 2007 pronouncement. Further details were provided on the information document requests, and on how to prosecute a claim for penalties under Section 6676(a).

Putting all of these things together, the government is communicating the following to the taxpayer:

> There are some things about the Section 41 credit that we really don't understand very well. In fact, we are not even sure how to communicate with the public about them. However, despite this unfortunate lack of guidance, we are still going to view section 41 claims with special care and a jaundiced eye. Further, we intend to take an aggressive posture toward penalizing the taxpayer whenever we can.
>
> But don't forget—research and development is crucial to our economy, and should be encouraged!

Now, consider how enthusiastic one might be about undertaking a risky project, involving research and development expenses, in today's economy.

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[72] In 2010, the IRS Large and Midsize Business Division (LMSB) became the Large Business and International Division (LB&I).

[73] LB&I cited four characteristics of these claims as a reason for its concerns:

1. High-level estimates,
2. Biased judgment samples,
3. Lack of nexus between the business component and qualified research expenses, and
4. Inadequate contemporaneous documentation.

[3] The Administration and Congress to the Rescue?

But there is hope. The Obama Administration wants to expand and simplify the credit. Also, it wants to make it permanent.[74]

In addition, Senators Baucus and Hatch, who are, respectively, the Chairman and Ranking Member of the Senate Finance Committee, have co-sponsored the Greater Research Opportunities with Tax Help (GROWTH) Act.[75] The GROWTH Act would allow the traditional Section 41 credit to expire, raise the percentage on the alternative simplified credit to 20 percent, and make the whole thing permanent.

Either the Administration proposal or the GROWTH Act would be a huge improvement. However, even if neither one of these proposals comes to fruition, one could at least hope that the current Section 41 credit will be extended once again. In any event, I wouldn't recommend trading in your gas-powered car just yet.

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[74] The Administration proposes to increase the rate of the simplified credit from 14% to 17%. Presumably, with a more generous simplified credit, the more cumbersome regular credit will become irrelevant. http://www.whitehouse.gov/sites/default/files/fact_sheet_re_credit_98-10.pdf; Report, U.S. Treas. Dep't., Office of Tax Policy, *Investing in U.S. Competitiveness: The Benefits of Enhancing the Research and Experimentation (R&E) Credit* (March 25, 2011) .

[75] S 1577, 112th Cong, 1st Sess. See Senate Finance Committee Press Release: Baucus, Hatch Look to Boost Innovative American Industries, Provide Certainty with Permanent Research and Development Credit. 2011ARD 180-7, Sept 19, 2011. For expressions of support for S 1577, *see* "alliantgroup Strongly Supports GROWTH Act," http://www.reuters.com/article/2011/09/21/idUS206853+21-Sep-2011+PRN20110921; TIA Applauds Bipartisan Introduction of GROWTH Act by Senate Finance Committee Leadership, http://tiaonline.org/news_events_press_releases/2011/PR-21_TIA_Applaud. ("TIA" is the Telecommunications Industry Association).

Suellen Wolfe on the Proposed Improvements to the Offshore Voluntary Disclosure Initiative

By Suellen Wolfe, J.D., LL.M.*

§ 3.01 Introduction

The Internal Revenue Code (IRC) requires U.S. taxpayers to report income and pay taxes on worldwide income.[1] Intentionally failing to report income earned on financial accounts or undisclosed assets may subject the taxpayer to significant penalties including the fraud and foreign information return penalties.[2] Criminal prosecution of the taxpayer is a possibility if the Internal Revenue Service (IRS) discovers required, but unreported, transactions.[3] Voluntarily disclosure of unreported accounts accompanied by related required information to the IRS and paying any taxes due achieves the taxpayer's compliance with the U.S. tax system. A voluntary disclosure occurs when communications between the taxpayer and the IRS's Criminal Investigation (CI) are timely, truthful, and completely disclose the transactions as required by the IRC.[4]

The worldwide economic crisis and the failure of the IRS to fulfill its enforcement duty with respect to defense of the U.S. tax base prompted an aggressive strategy to address international tax issues. This included staff increases for the IRS and a renewed focus on the perceived U.S. tax base abuse through use of offshore financial institutions.

§ 3.02 Data Mining – Foreign Banks

Foreign banks have been the focus of U.S. Justice Department investigations into allegations of facilitation of tax evasion.[5] U.S. officials constantly seek statistical data on foreign banks' U.S.

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[1] IRC §§ 61, 861-865. See also, IRS Publication 17 at Part Two, 5 (2011).

[2] See e.g., IRC §§ 6038, 7203, 7206 & 7207.

[3] Possible criminal charges related to tax returns include tax evasion (26 US. § 7201), filing a false return (26 USC § 7206(1)) and failure to file an income tax return (26 USC § 7203). Willfully failing to file an FBAR and willfully filing a false FBAR are both violations that are subject to criminal penalties under 31 USC § 5322. FBAR is the acronym for IRS Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts. A person convicted of tax evasion is subject to a prison term of up to five years and a fine of up to $250,000. Filing a false return subjects a person to a prison term of up to three years and a fine of up to $250,000. A person who fails to file a tax return is subject to a prison term of up to one year and a fine of up to $100,000. Failing to file an FBAR subjects a person to a prison term of up to ten years and criminal penalties of up to $500,000.

[4] IRM 9.5.11. A voluntary disclosure occurs when the communication is truthful, timely, complete, and when the taxpayer shows a willingness to cooperate (and does in fact cooperate) with the IRS in determining his or her correct tax liability; and the taxpayer makes good faith arrangements with the IRS to pay in full, the tax, interest, and any penalties determined by the IRS to be applicable. *Id*. at (3).
A disclosure is timely if it is received before IRS has initiated a civil examination or criminal investigation of the taxpayer, or has notified the taxpayer that it intends to commence such an examination or investigation; the IRS has received information from a third party (e.g., informant, other governmental agency, or the media) alerting the IRS to the specific taxpayer's noncompliance; the IRS has initiated a civil examination or criminal investigation which is directly related to the specific liability of the taxpayer; or the IRS has acquired information directly related to the specific liability of the taxpayer from a criminal enforcement action (e.g., search warrant, grand jury subpoena). *Id*. at (4).

[5] On December 12, 2007, Igor Olenicoff, president and owner of Olen Properties Corporation, pleaded guilty to filing a false tax return for tax year 2002 related to foreign bank accounts he failed to disclose to the IRS. Olenicoff paid $52 million to the IRS for six years of back taxes, penalties and interest as part of his plea agreement. Olenicoff was sentenced in April 2008 to two years probation and 120 hours of community service. IRS Announcement and Documents, Offshore Tax-Avoidance and IRS Compliance Efforts (December 13, 2011).

accountholders. In a high profile example, Swiss officials resisted divulging specific individual information asserting such disclosure violated Swiss law.[6]

On July 21, 2008, the IRS issued a "John Doe Summons" to then Zurich-based UBS AG (formerly the Union Bank of Switzerland) seeking information concerning client accounts.[7]

In January 2009, the U.S. and Switzerland agreed to increase the interchange of tax information to crack down on tax evasion. In February 2009, the IRS petitioned the U.S. District Court in Miami to forced UBS AG to turn over names of some 52,000 U.S. clients believed to be hiding nearly $15 billion in assets in secret accounts.[8] UBS AG and the Swiss government resisted arguing that to do so would violate long standing Swiss banking confidentiality laws. Swiss private banking law distinguishes between a civil action that is the rarely prosecuted tax evasion and the criminal prosecution of tax fraud.

On February 18, 2009, UBS AG entered into a deferred prosecution agreement on charges of conspiring to defraud the United States by impeding the IRS. UBS AG agreed to pay $780 million in fines, penalties, interest and restitution and to reveal the names of U.S. clients in a deferred prosecution agreement with the U.S. Justice Department. UBS AG admitted helping U.S. citizens evade taxes, which experts ultimately determined was not a violation of Swiss bank secrecy laws apparently as a result of a broad interpretation of bank secrecy laws. UBS AG admitted to criminal wrongdoing in selling offshore banking services that promoted tax evasion.

In May 2009, the Department of Justice and IRS began announcing that the first UBS AG clients pleaded guilty to tax evasion.[9] Steven Michael Rubinstein, a Boca Raton accountant, pleaded guilty to filing a false 2004 tax return by failing to disclose the existence of a Swiss bank account maintained by UBS AG of which he was the beneficial owner. Rubinstein failed to report any income earned on that account.[10]

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[6]The Wall Street Journal, U.S. Pushes on Banks, Switzerland Pushes Back, September 6, 2011at p. C9.
[7]A John Doe Summons is a nickname for a summons issued under IRC § 7602 that does not specifically identify the taxpayer under investigation. Westin, Richard A., WG&L Tax Dictionary.
[8] US v UBS AG, Case No. 09-20423. On June 30, 2008, the Justice Department filed papers seeking an order from a federal court in Miami, Florida authorizing the IRS to use a John Doe summons to request information from UBS AG about U.S. taxpayers who may be using Swiss bank accounts to evade federal income taxes. IRS Announcement and Documents, Offshore Tax-Avoidance and IRS Compliance Efforts, (December 13, 2011).
[9]Robert Moran pleaded guilty to a criminal information charging him with filing a false income tax return. Moran concealed more than $3 million in assets in a secret bank account at UBS in Switzerland. Moran was sentenced to two months in prison and one year of supervised release with five months in home confinement. U.S. Dep't of Justice Office of Public Affairs, Justice News, UBS Client Pleads Guilty to Filing False Tax Return Hid Assets Worth $3 Million in Secret Swiss Bank Account (April 14, 2009).
The UBS AG offshore banking scandal was purportedly prompted by a whistleblower, Bradley Birkenfeld, a former UBS AG private banker. A 2006 tax-informant law, designed to encourage people to report cases of tax evasion, provides for an award of between 15% and 30% of the tax proceeds the IRS recovers as a result of the informant's information. Mr. Birkenfeld was sentenced on August 21, 2009 to more than three years in prison. Mr. Birkenfeld's asserts that his disclosures led directly to the agreement between the U.S. and UBS AG for the payment of $780,000,000.00 in fines and penalties. His disclosures led to the creation of an IRS 2009 OVDI, in which illegal secret accounts were disclosed resulting in the recovery of billions of dollars by the IRS. Mr. Birkenfeld's whistleblower contributions also led to the termination of the illegal UBS AG program that existed to solicit and encourage wealthy U.S. taxpayers to hide their money in offshore accounts. See The Wall Street Journal, Deals & Deal Makers, Oct 16, 2009, p. C3. Mr. Birkenfeld reported for prison the Federal Correctional Institute on January 8, 2010.
On May 13, 2008, banker Mario Staggl was indicted for conspiring with Birkenfeld to assist an U.S. billionaire real estate developer evade paying $7.2 million in taxes by assisting in concealing $200 million of assets in Switzerland and Liechtenstein. IRS Announcement and Documents, Offshore Tax-Avoidance and IRS Compliance Efforts (December 13, 2011).
[10] U.S. Dep't of Justice Office of Public Affairs, Justice News, "UBS Client Pleads Guilty to Filing False Tax Return" (April 14, 2009). Steven M. Rubinstein was sentenced on Oct. 28, 2009, to three years probation, of which 12 months will be served in home detention.

On August 19, 2009, the Swiss and U.S. governments announced an agreement regarding the John Doe summons filed in which the U.S. demanded the identities of suspected tax dodgers on June 30, 2008.[11] UBS AG agreed to reveal the names of U.S. clients suspected by the IRS of using the bank's offshore services to evade U.S. taxes. If the affected taxpayers also utilized voluntary disclosure, the submission triggered the withdrawal of prosecution, the "John Doe summons," but did not affect UBS AG's obligation under the agreement.[12]

A tax treaty between Switzerland and the U.S. forms the legal basis for requiring UBS AG to identify clients with undisclosed private banking accounts.[13] According to IRS documents, the UBS AG agreement disclosed U.S. clients who had unreported accounts of at least a million Swiss francs (about $988,000) and also disclosed U.S. taxpayers who were the owners of secret offshore sham company accounts. The taxpayers are identified as those having UBS AG accounts covering 2001 through 2008. For accounts that UBS AG deemed to have involved "tax fraud or the like," the balance may be less than a million Swiss francs but more than 250,000 Swiss francs (about $247,000).[14] UBS AG agreed to disclose accounts for which holders did not file a special disclosure document[15] over at least three years since 1998, and for which the accounts generated annual revenue to the client of at least 100,000 Swiss francs. UBS AG agreed in 2009 to pay $780 million in fines, penalties, interest and restitution as part of the deferred prosecution agreement with the U.S. government.[16]

The IRS and U.S. Justice Department are making requests of other financial institutions operating in Switzerland for similar accounts.[17] U.S. taxpayers who contested the handover in Swiss courts are obligated to notify the U.S. Attorney General of their challenge which, in effect, identified them to the IRS.

The Foreign Account Tax Compliance Act (FATCA), enacted in 2010, requires certain U.S. taxpayers holding foreign assets outside of the U.S. to report those assets to the IRS.[18] The FATCA will require foreign financial institutions to report directly to the IRS certain information about financial accounts held by U.S. taxpayers, or by foreign entities in which U.S. taxpayers hold a substantial ownership interest.[19] Apparently some banks are terminating their customers as a result of the FATCA requirements. Munich-based HypoVereinsbank reportedly sent letters to clients advising them it will terminate securities services for customers who live in the U.S. at the end of the year.[20] This includes U.S. nationals who live abroad.

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[11] IR-2009-75 (August 19, 2009).
[12] *Id*.
[13] Convention between the U.S. and the Swiss Federation for the Avoidance of Double Taxation with Respect to Taxes on Income (October 2, 1996) as amended by Agreement between the U.S. and The Swiss Confederation (August 19, 2009).
[14] A 2003 Mutual Agreement on Information Exchange interpreting Article 26 of the Switzerland-2 income tax treaty was intended to facilitate more effective tax information exchange in cases involving civil or criminal tax fraud or the like. Tax fraud or the like is the concealment of funds, the submission of incorrect or false documents to UBS AG or the IRS, and what the IRS terms a scheme of lies.
[15] Form W-9, Request for Taxpayer Identification Number and Certification.
[16] *Id*.
[17] U.S. Cong., Joint Committee Report, JCX-31-11 (May 20, 2011). Switzerland's second largest bank, Credit Suisse, has apparently started to reveal the names of U.S. taxpayers with hidden accounts and may be facing hundreds of millions of dollars in fines for its role in helping these taxpayers evade U.S. taxes. Other banks have reportedly turned over statistical data to the U.S. including Wegelin and Julius Baer. "Credit Suisse to Hand Over Account Data," Wall Street Journal (November 8, 2011).
[18] 111 PL 312, 124 Stat 3296.
[19] IR-2011-117 (Dec 14, 2011).
[20] "Banks Sweat as Tax Net Tightens," The Wall Street Journal (December 29, 2011), p C2.

§ 3.03 The Offshore Voluntary Disclosure Initiatives

From 1934 to 1952, the IRS policy prohibited prosecution of taxpayers making voluntary disclosures.[21] In subsequent years, the IRS considered voluntary disclosure in determining whether criminal prosecution would be pursued.[22] In 2003, the IRS initiated its brief, and largely unsuccessful, Overseas Voluntary Compliance Initiative (OVCI).[23] The 2003 Initiative was essentially a one-time amnesty permitting taxpayers with foreign financial transactions and assets to file corrective amended returns. The program was in place from January 14, 2003 to April 15, 2003.

On March 23, 2009, the IRS commenced the 2009 Offshore Voluntary Disclosure Initiative (2009 OVDI) encouraging taxpayers with secreted offshore income and assets to resolve all outstanding offshore tax issues. The 2009 OVDI intended to improve consistency in handling voluntary disclosure cases. It included a uniform penalty structure with the opportunity to calculate the total cost of voluntary disclosure compliance.[24] The program enabled taxpayers who reported to the IRS voluntarily to avoid criminal prosecution.[25] On May 6, 2009, the IRS published 30 Frequently Asked Questions (FAQs) providing guidance about operation of the 2009 OVDI .[26] The IRS solicited the assistance of the U.S. Justice Department to identify tax-avoiding taxpayers with Swiss bank accounts.

The 2009 FAQs provided that taxpayers were required to file accurate amended or delinquent tax returns[27] for the past six years.[28] The IRS provided an eight-question form letter that taxpayers could utilize to provide the information necessary to process the voluntary disclosure.[29] The 2009 FAQs emphasized that taxpayers reporting previously unreported offshore accounts will not be treated as a voluntary disclosure. These taxpayers may be subject to large civil penalties and possible criminal prosecutions.[30]

Under the 2009 OVDI, the reduced penalty framework provided to taxpayers filing voluntary disclosure requests (accepted by the IRS between March 23 and October 15, 2009) the ability to pay and discharge the obligation of back taxes, interest, and either an accuracy-related[31] or delinquency-related penalty[32] on up to 6 years of unreported income. A miscellaneous offshore penalty equal to 20 percent of the amount in the foreign bank accounts in the year with the highest aggregate account or asset value was also included.[33]

[21] See R. Hebel, CA-8, 82-1 USTC ¶9162, 668 F2d 995, at 997 (1982).
[22] *Id*., at 999, citing the U.S. Department of Justice Manual for Criminal Tax Trials, Ch.1, at 5 (1973).
[23] Rev Proc 2003-11, 2003-4 IRB 311.
[24] IR, Voluntary Disclosure: Questions and Answers No. 12 *(FAQ)(May 6, 2009 — Q&A 1-30 posted;* June 24, 2009 — modified A26 and added Q&A 31-51; July 31, 2009 — modified A6, A21 and A22; August 25, 2009 – added Q&A 52; January 8, 2010 – added Q&As 53-54).
[25] IR Newsroom, Statement from IRS Commissioner Doug Shulman on Offshore Income (March 26, 2009).
[26] FAQ 9.
[27] IRS Form TDF 90-22.1 (Report of Foreign Banks and Financial Accounts)(FBAR).
[28] FAQ 26 requires that taxpayers use the current version of the FBAR form.
[29] FAQ 6.
[30] FAQ 10.
[31] IRC§ 6662 provides for an accuracy-related penalty that is generally equal to 20 percent of the portion of the underpayment attributable to negligence, substantial understatement, substantial valuation misstatement, or any undisclosed foreign asset understatement.
[32] IRC § 6651 provides for a delinquency penalty for failure to file or pay tax by the due date of the return.
[33] This penalty is reduced to five percent if the taxpayer did not open the account, ii) there was no account activity while the taxpayer controlled the account, and iii) all taxes on the account have been paid.

The IRS regarded the 2009 OVDI, which ended on October 15, 2009, as a success with approximately 15,000 taxpayers making disclosures.[34] The 2009 OVDI resulted in nearly $ 2.2 billion in collections, with nearly 80 percent of applications closed.[35]

Although the 2009 OVDI was outwardly successful, flaws in the voluntary disclosure system became apparent to tax practitioners. Inflexibility and confusion with the imposition of penalties, the interpretation of the "willfulness" element of evading taxes, and onerous paperwork requirements affected the effectiveness of the 2009 OVDI. The speed through which taxpayers moved through IRS Examination was criticized. CI, in contradiction to prior policy, enforced a strict time frame assessing taxpayers who were under audit during the period of March 23, 2009 to October 15, 2009.[36] The submission of these taxpayers was deemed to be untimely despite the fact that the audit was closed prior to the taxpayer's disclosure.

On February 8, 2011, the IRS announced the 2011 Offshore Voluntary Disclosure Initiative (2011 OVDI).[37] This initiative was a counter-part to CI's Voluntary Disclosure Practice outlined in the IRS Manual.[38] Like its predecessor, the 2011 OVDI addressed the civil side of a taxpayer's voluntary disclosure by defining the number of tax years covered and setting the applicable civil penalties.

The 2011 OVDI differed from the 2009 OVDI requiring taxpayers to pay back taxes, interest, and either an accuracy-related or delinquency-related penalty on up to 8 years (if applicable) of unreported income.[39] The miscellaneous offshore penalty was also raised from 20 to 25 percent of the amount in the foreign bank accounts in the year with the highest aggregate account balance covering the tax years 2003 to 2010 time period.[40] However, some taxpayers were eligible for a reduced rate of 5 (applicable in limited conditions) or 12.5 percent for those offshore accounts or assets that did not surpass $ 75,000 in any calendar year covered by the 2011 OVDI.[41] Additional taxpayer submission requirements of the 2011 OVDI were more extensive than the 2009 OVDI.[42]

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[34] Department of Justice Release, Justice Department and IRS Announce Results of UBS AG Settlement and Unprecedented Response in Voluntary Disclosure Program at p. 5 (November 17, 2009).
[35] FAQ 7.
[36] *Id*.
[37] IR-2011-14 (Feb. 8, 2011).
[38] IRM 9.5.11.9 *et seq*.
[39] TIGTA Report at 3.
[40] IR-2011-94 (Sept. 15, 2011).
[41] *Id*.
[42] Pursuant to the submission requirements of the 2011 OVDI, the taxpayer must:

- Provide copies of previously filed original (and, if applicable, previously filed amended) federal income tax returns for tax years covered by the voluntary disclosure;
- Provide complete and accurate amended federal income tax returns (for individuals, Form 1040X, or original Form 1040 if delinquent) for all tax years covered by the voluntary disclosure, with applicable schedules detailing the amount and type of previously unreported income from the account or entity (e.g., Schedule B for interest and dividends, Schedule D for capital gains and losses, Schedule E for income from partnerships, S corporations, estates or trusts).
- File complete and accurate original or amended offshore-related information returns (see FAQ 29 for certain dissolved entities) and Form TD F 90-22.1 (Report of Foreign Bank and Financial Accounts, commonly known as an "FBAR") for calendar years 2003 through 2010;
- Cooperate in the voluntary disclosure process, including providing information on offshore financial accounts, institutions and facilitators, and signing agreements to extend the period of time for assessing tax and penalties;
- Pay 20% accuracy-related penalties under IRC § 6662(a) on the full amount of your underpayments of tax for all years;
- Pay failure to file penalties under IRC § 6651(a)(1), if applicable;
- Pay failure to pay penalties under IRC § 6651(a)(2), if applicable;
- Pay, in lieu of all other penalties that may apply, including FBAR and offshore-related information return penalties, a miscellaneous Title 26 offshore penalty, equal to 25% (or in limited cases 12.5% (see FAQ 53) or 5% (see FAQ 52)) of

The 2011 OVDI ended on September 9, 2011.[43] IRS Commissioner Douglas Shulman announced applications for disclosure approached 12,000 and that a current "down payment" of $ 500 million has been made in collected taxes and interest. [44] Taxpayers who decided to opt out of the 2011 OVDI program were warned that "there are no guarantees that they would get the same deal" as those who voluntarily disclosed.[45]

§ 3.04 IRS Internal Procedure and Voluntary Disclosure Practice

The Internal Revenue Manual requires that special agents[46] evaluate each voluntary disclosure request to determine if the information provided by the taxpayer is truthful and complete.[47] A suggestion must be expressed to the special agent in charge[48] indicating to whether the taxpayer has met all voluntary disclosure practice criteria.[49]

Timely evaluation of the numerous voluntary disclosure requests enabled the CI to identify necessary steps to ensure proper evaluation.[50] These included the assignment of additional special agents to the evaluation process and eliminating mandatory taxpayer interviews replacing them with the optional offshore voluntary disclosure letter.[51] In certain cases, this reduced the number of voluntary disclosures requiring personal contact of the taxpayer and case documentation requirements.[52] The CI secured major case funding in the 2010 fiscal year enabling it to scan and electronically search 2009 OVDI documents for patterns of financial institutions, promoters[53] and international countries.[54]

Current IRS practice creates no substantive or procedural rights for taxpayers considering voluntary disclosure.[55] However, a voluntary disclosure is one consideration in the investigation in determining whether

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the highest aggregate balance in foreign bank accounts/entities or value of foreign assets during the period covered by the voluntary disclosure;

- Submit full payment of all tax, interest, accuracy-related penalty, and, if applicable, the failure to file and failure to pay penalties with the required submissions set forth in FAQ 25 or make good faith arrangements with the IRS to pay in full, the tax, interest, and these penalties (see FAQ 20 for more information regarding a taxpayer's ability to fully pay) (the suspension of interest provisions of IRC § 6404(g) do not apply to interest due in this initiative); and Execute a Closing Agreement on Final Determination Covering Specific Matters, Form 906.

IR, 2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers, FAQ 7 (Aug 29, 2011).

[43] IR-2011-94, Sept. 15, 2011.

[44] *Id*.

[45] IR Release Doc 2011-19648.

[46] A special agent is an IRS agent whose functions relate to penalties, fraud, and criminal cases. . Westin, Richard A., WG&L Tax Dictionary. Such agents are empowered to execute and serve search and arrest warrants, make arrests for violating the internal revenue laws that occur in the agents presence, or seize property subject to forfeiture pursuant to the revenue laws. IRC § 7608.

[47] IRM 9.5.11.9.7.

[48] A special agent in charge is responsible for directing, monitoring, and coordinating the criminal investigation activities of special agents within their assigned office's area of responsibility. TIGTA Report at fn.9.

[49] IRM 9.5.11.9.7.1.

[50] IRM 9.5.11.9.7.1 & .2.

[51] IRM 9.5.11.9.6.

[52] TIGTA Report at p. 6.

[53] Promoters are defined as individuals who assist taxpayers in setting up elaborate financial schemes to subvert and evade tax laws. TIGTA Report at fn. 13.

[54] This system became the CI's Voluntary Disclosure Analysis capability used for data mining to further the IRS's understanding of how foreign accounts and foreign entities promote ways to avoid or evade tax.

[55] IRM 9.5.11.9.1.

criminal prosecution is recommended.[56] Individual taxpayer cases are directed to CI for evaluation of the disclosure.[57]

§ 3.05 Recommended Improvements to Voluntary Disclosures – The TIGTA Report

On September 21, 2011, the U.S. Treasury Inspector General for Tax Administration (TIGTA) included in its 2011 Annual Audit Plan an acknowledgement that the IRS's 2009 OVDI increased compliance.[58] But the TIGTA also noted shortcomings in the IRS's voluntary disclosure practices. The audit chronicled the 2009 OVDI as an unprecedented effort within the IRS requiring the combination of resources and the coordination of efforts between CI, the Large Business and International Division (LB&I) and Small Business/Self-Employed (SB/SE) Division, and the Office of Chief Counsel.[59] The voluntary disclosure practices demonstrated by the IRS were effective and the assignment and verification of cases was appropriate despite the receipt of a high volume of disclosure requests.[60] A survey of tax practitioners viewed the 2009 OVDI as a positive program.[61]

The TIGTA Report concluded that additional insight is needed to ensure information obtained from voluntary disclosures is accurate and complete.[62] As part of the voluntary disclosure verification process, revenue agents are required to certify that the taxpayer's amended or newly filed delinquent tax returns are complete and accurate.[63] The TIGTA audit report focused on whether sufficient safeguards were in place to ensure that taxpayers were fully disclosing all unreported income. The TIGTA suggested requiring taxpayers to provide more details on unreported income and developing a process within the IRS to ensure proper transcription of data.

Specifically, the TIGTA recommended as a part of the voluntary disclosure agreement process that the IRS Commissioner of LB & I require taxpayers (or their representatives) to prepare a reconciliation of all unreported income from offshore accounts to the schedule and line item on the amended or newly filed delinquent income tax returns. To this end, the IRS had already implemented this recommendation as a requirement of the 2011 OVDI. IRS examiners reviewing 2011 OVDI applications are required to verify the correctness of amended returns.[64]

Whether there is an adequate review process in place to ensure the accuracy of 2009 OVDI closing agreements was also challenged by the TIGTA.[65] The TIGTA Report continues that the Commissioners of the LB&I and SB/SE Divisions should require revenue agents to initial the lower-right corner on the back of each page of the Form 906[66] before sending it to the taxpayer for signature to ensure the integrity of the closing agreement and prevent to taxpayers intentionally altering these documents to their financial benefit.[67]

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[56] *Id*.
[57] IRM 9.5.11.9.7.
[58] TIGTA Report at p. 4.
[59] *Id*. at p. 4.
[60] *Id*. The 2009 OVDI generated more than 55,000 unexpected high-priority income tax returns into the examination workflow for both the LB&I and SB/SE Divisions of the IRS. The IRS reassigned agents and trained additional support personnel . As of March 2011, the IRS completed verification of 3,637 cases that included 18,494 tax returns involving additional revenues of approximately $ 784 million including tax, penalties, and interest. Id. at p. 7.
[61] *Id*. at p. 8.
[62] *Id*. at p. 9.
[63] *Id*. at fn 21 & Appendix VII.
[64] *Id*. at p. 12.
[65] *Id*.
[66] IRS Form 906, Closing Agreement on Final Determination Covering Specific Matters.
[67] Closing Agreement is a written agreement between a taxpayer and authorized IRS official pursuant to which tax liabilities and facts, …, can be finally and irrevocably settled, except for a misrepresentation or as to future laws, whether previously disputed or not. Westin, Richard A., WG&L Tax Dictionary. The OVDI closing agreement

IRS management disputed this recommendation. The IRS's practice experience is that taxpayers and representatives rarely make hidden changes to documents prior to signing and returning them to the IRS for execution. The IRS explained that it does not believe it is beneficial to make this "initialing" practice a requirement because it will result in perfectly valid closing agreements being returned to taxpayers for re-execution.[68] The IRS finds that taxpayers often sign and return photocopies of Form 906. The IRS elaborated that it has not encountered a single OVDI closing agreement where the taxpayer or representative has altered an agreement before returning it. It is the observation of the IRS that initialing is the best practice to make it easy for reviewers to verify the original was signed.[69] The IRS also elaborated that the SB/SE Technical Services performs a second-level review of all taxpayer signed closing agreements.[70]

The IRS established the E-Trak Offshore Voluntary Disclosure Program (E-Trak) system during the 2009 OVDI to control, monitor and evaluate the success of the program.[71] The final recommendation of the TIGTA Report is the development of a quality review process to ensure that all taxpayer data relating to financial accounts, promoters, and professional information involving voluntary disclosures are properly transcribed into the E-Trak[72] system. The TIGTA cautions that the success of future data mining for trending noncompliance is at stake. Noting the system's short-comings, the IRS plans to implement procedures to conduct a 100 percent review of inputs to the E-Trak system.

§ 3.06 Conclusion

The 2011 TIGTA audit verified that impediments to the success of the IRS's 2009 OVDI were largely overcome by internal modifications in IRS operations. The report observes that thousands of U.S. taxpayers were brought back into compliance by requiring them to properly report and pay taxes on their offshore accounts.[73] Another accomplishment of the 2009 OVDI was the requirement that these participating taxpayers continue to properly disclose all foreign source income when submitting future income tax returns.[74]

The true impact of the OVDIs may be the information and intelligence derived from taxpayer data elicited and processed. On January 9, 2011, the IRS announced essentially an indefinite continuation of the 2011 OVDI with an increased penalty rate of 27.5 percent.[75] The open deadline will continue to put pressure on U.S. taxpayers with overseas accounts to report and pay taxes on these accounts.

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procedures recommend revenue agents "print the closing agreements on IRS watermarked paper or place your initials in blue ink on the lower-right corner on the back of each page of the closing agreements to insure that the closing agreements you receive back from the taxpayer or representative are the same agreements you sent to the taxpayer or representative." TIGTA Report at p. 10.

[68] *Id*. at p. 12.
[69] *Id*.
[70] *Id*.
[71] *Id*. at p.11.
[72] *Id*. at pp. 11-12. The electronic Voluntary Disclosure Program provides the IRS's Large Mid Size Business organization with the flexibility to store, retrieve, update, and track taxpayer data relative to Voluntary Disclosure information of international offshore transactions. Upon account establishment, cases are assigned to Revenue Officers, Agents, and Examiners in the field to follow-up with taxpayers to obtain background and financial data concerning a taxpayer's offshore transactions with the emphasis on detecting unreported income.
[73] *Id*. at p. 7.
[74] *Id*.
[75] IR 2012-5.

Howard Godfrey on Accuracy-Related Penalties under Internal Revenue Code Section 6662

By Howard Godfrey, Ph.D., CPA*

§ 4.01 Penalty Assessment Statistics

In an era of budget deficits, the IRS is dramatically increasing the number and amount of accuracy-related penalties assessed, especially for individuals. In 2005, 58,366 accuracy-related penalties were assessed on individuals for a total of $325 million in penalties. By 2010, the number had increased by 700 percent to 469,321, resulting in total penalties assessed of $1 billion, an increase of 228 percent. The number of corporations assessed such penalties grew from 1,342 to 3,640, although the increase in the amount of such penalties was not substantial.[1]

The IRS is expected to continue to place great emphasis on accuracy-related penalties. On June 4, 2010, the Treasury Inspector General for Tax Administration (TIGTA) published a review of 229 correspondence audits closed in Fiscal Year (FY) 2008. The study found 211 (92 percent) audits for which penalties were not considered and assessed in accordance with IRS policies and procedures. As a result, opportunities may have been missed to enhance Federal revenue from penalties and interest by approximately $395,000 from that group. An earlier study reported that IRS field examiners were either too lenient and did not recommend penalties that were warranted or had not documented case files indicating that applicable penalties were considered in 35 of 45 corporate audits reviewed. The 2010 report by the TIGTA indicates that the IRS agreed to require managers and examiners to properly complete accuracy-related penalty lead sheets for all applicable audits.

§ 4.02 Section 6662 Accuracy-Related Penalty

Section 6662(a) of the Internal Revenue Code imposes an accuracy-related penalty equal to 20 percent of the underpayment to which Section 6662 applies. An understatement is equal to the excess of: (1) the amount of tax required to be shown in the tax return over (2) the amount of tax shown in the return.[2]

[1] Penalty for Negligence or Disregard of Rules

The first two categories of penalties under Section 6662 involve underpayments attributable to: (1) negligence under Section 6662(b)(1), or (2) disregard of rules or regulations under Section 6662(b)(2). The penalties apply, regardless of the amount of the understatements.

Negligence has been defined as a failure to do what a reasonable person would do under the circumstances.[3] The term "negligence" includes any failure to make a reasonable attempt to comply with the provisions of the internal revenue laws or to exercise ordinary and reasonable care in the preparation of a tax return. "Negligence" also includes a failure to keep adequate books and records or to substantiate items properly. Negligence is strongly indicated where:

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[1] http://www.irs.gov/taxstats/bustaxstats/article/0,,id=207459,00.html. Table 17. Civil Penalties Assessed and Abated, by Type of Tax and Type of Penalty, Fiscal Year 2010. Includes IRC §§ 6662 and 6662A penalties.
Table 27. Civil Penalties Assessed and Abated, by Type of Tax and Type of Penalty, Fiscal Year 2005

[2] This article does not cover Section 6662A, which imposes an accuracy-related penalty on understatements involving reportable transactions.

[3] Leuhsler v Comm'r, 963 F2d 907 (1992).

1) A taxpayer fails to include on an income tax return an amount of income shown on an information return, as defined in Section 6724(d)(1);
2) A taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return which would seem to a reasonable and prudent person to be "too good to be true" under the circumstances;
3) A partner fails to comply with the requirements of Section 6222, which requires that a partner treat partnership items on its return in a manner that is consistent with the treatment of such items on the partnership return (or notify the Secretary of the inconsistency); or
4) A shareholder fails to comply with the requirements of Section 6242, which requires that an S corporation shareholder treat subchapter S items on its return in a manner that is consistent with the treatment of such items on the corporation's return (or notify the Secretary of the inconsistency).[4]

[2] Duty of Taxpayer

In *Woodsum v. Commissioner*, [5] taxpayer Stephen Woodsum received income of $33 million, reported on over 160 information returns, which he provided to his accounting firm. About $3.4 million of income reported on one Form 1099-MISC was not included in the 115-page individual return prepared by his tax firm. Woodsum met with the tax firm personnel to review the return. He did not compare or match the items of income reported on the Form 1040 with the information returns. The IRS determined a deficiency of $521,473 and an accuracy-related penalty of $104,295. Woodsum argued he was not liable for the penalty because he had reasonable cause for the omission and had acted in good faith, based on his reliance on a professional tax firm to prepare his return. However reliance on a tax professional is typically a defense when there is a difficult question involving interpretation of the tax law. A taxpayer who relies on a tax professional still has a personal responsibility to review the return for accuracy before signing it. The Tax Court stated that in evaluating reasonable cause, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability.[6] Woodsum failed to prove the “most important factor.” He did not fulfill his duty to review the return prepared by the accounting firm. The court could not hold that this understatement was attributable to reasonable cause and good faith.

[3] Disregard of Rules or Regulations: Definitions

The term “disregard” includes any careless, reckless, or intentional disregard.[7] A disregard of rules or regulations is "careless" if the taxpayer does not exercise reasonable diligence to determine the correctness of a return position that is contrary to the rules or regulations.

A disregard is "reckless" if the taxpayer makes little or no effort to determine whether a rule or regulation exists, under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable person would observe. A disregard is "intentional" if the taxpayer knows of the rule or regulation that is disregarded.

The term "rules or regulations" includes the provisions of the Internal Revenue Code, temporary or final Treasury regulations issued under the Code, and revenue rulings or notices (other than notices of proposed rulemaking) issued by the Internal Revenue Service and published in the Internal Revenue Bulletin.[8]

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[4] Treas Reg § 1.6662-3.
[5] 136 TC 585 (June 13, 2011).
[6] See Treas Reg § 1.6664-4(b)(1).
[7] IRC § 6662(c).
[8] Treas Reg § 1.662-3(b)(2).

[4] Penalty for Substantial Understatement of Tax

The Section 6662 penalty also applies to an underpayment that is "substantial." An understatement is substantial in the case of an individual or an S corporation if the amount of the understatement for the taxable year exceeds the greater of: (1) ten percent of the tax required to be shown in the tax return for that year, or (2) $5,000.[9]

For a corporation other than an S corporation or a personal holding company, there is a substantial understatement of income tax if the amount of the understatement for the taxable year exceeds the lesser of: (1) ten percent of the tax required to be shown on the return for the taxable year (or, if greater, $10,000), or (2) $10,000,000.

[5] Penalty for Misstatement of Asset Value or Pension Liability

The 20 percent penalty may apply to an understatement of income tax caused by a substantial valuation misstatement. The misstatement is substantial if the value or basis of property is 150 percent or more of the amount determined to be correct. If the value misstatement is 200 percent or more, the penalty rate is 40 percent rather than 20 percent.

For related party transactions, the misstatement is substantial if: (1) the price of property is 200 percent or more (or 50 percent or less) than the correct amount, or (2) the net Section 482 adjustment is more than the lesser of $5,000,000 or 10 percent of the taxpayer's gross receipts. The penalty rate is 40 percent rather than 20 percent, if: (1) the price of property is 400 percent or more (or 25 percent or less) than the correct amount, or (2) the net Section 482 adjustment is more than the lesser of $20,000,000 or 20 percent of the taxpayer's gross receipts.

An overstatement of pension liabilities is substantial if the actuarial determination of the liabilities taken into account for purposes of computing the deduction under paragraph (1) or (2) of section 404(a) is 200 percent or more of the amount determined to be the correct amount of such liabilities. The penalty rate is 40 percent rather than 20 percent, pension liabilities are overstated by 400 percent. However, the penalty is not imposed unless the portion of the underpayment for the year attributable to substantial overstatements of pension liabilities exceeds $1,000.

An estate or gift tax valuation understatement is substantial if the value of any property claimed on any return of tax imposed by subtitle B is 65 percent or less of the correct amount. The penalty rate is 40 percent rather than 20 percent, if the reported property value is 40 percent or less than the correct amount. The penalty is not imposed unless the portion of the underpayment attributable to substantial estate or gift tax valuation understatements for the taxable period (or, in the case of the tax imposed by chapter 11, with respect to the estate of the decedent) exceeds $5,000.

[6] Penalty for Transaction Lacking Economic Substance, or Undisclosed Asset

An enhanced penalty rate of 40 percent may apply to an understatement of income tax related to a noneconomic substance transaction, if the relevant facts affecting the tax treatment are not disclosed on the tax return or in a statement attached to the return. Changes made on an amended return are not considered in the computation, if the amended return is filed after the IRS has contacted the taxpayer regarding an examination of the return.

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[9] IRC § 6662(d)(1)(A).

An enhanced penalty rate of 40 percent may also apply to an understatement of income tax related to transaction involving an undisclosed foreign financial asset. This penalty applies when taxpayer fails to provide information required by Section 6038, 6038B, 6038D, 6046A, or 6048.

[7] Burden of Proof

In the U.S. Tax Court, determinations in an IRS notice of tax deficiency are generally presumed correct, and the taxpayer bears the burden of proving that those determinations are erroneous.[10] The burden of proof may shift to the IRS if the taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the income tax liability of the taxpayer. However, the burden is shifted only if the taxpayer has complied with substantiation requirements of the tax law, has maintained all required records and has cooperated with reasonable requests by the IRS for documents, meetings, interviews, witnesses, etc.[11] For example, the taxpayer may dispute the accuracy of an information return, and this may shift the burden to the IRS. In contrast, the IRS bears the burden of proof with respect to penalties.[12]

§ 4.03 Penalty Reduction for Authority of Position or Reasonable Cause

The penalty does not apply to an understatement if there is or was substantial authority for the taxpayer's treatment of the item. Alternatively, the penalty may be avoided if there is a reasonable basis for the treatment of the item by the taxpayer and the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return. However, penalties for tax shelters are not reduced as a result of having substantial authority or a reasonable basis and disclosure.

[1] Substantial Authority

A taxpayer can show that there is substantial authority for the tax treatment of an item by showing that the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists. There may be substantial authority for more than one position with respect to the same item. It is important to note that the substantial authority standard is an objective standard, and the taxpayer's belief that there is substantial authority for the tax treatment of an item is not relevant in determining whether there is substantial authority for that treatment.

Substantial authority for a tax position may be found in applicable provisions of the Internal Revenue Code and other statutory provisions; proposed, temporary and final regulations construing such statutes; revenue rulings and revenue procedures; tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties; court cases; congressional intent as reflected in committee reports, etc. The type of document also must be considered. For example, a revenue ruling is accorded greater weight than a private letter ruling addressing the same issue.[13]

[10] Most recent cases involving Section 6662 were tried in the U.S. Tax Court. The taxpayer may choose to pay the penalty and sue for a refund in another Federal court.
[11] IRC § 7491(a).
[12] IRC § 7491(c).
[13] Treas Reg § 1.6662-4(d).

[2] Reasonable Basis

Reasonable basis is a relatively high standard of tax reporting that is significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the tax authorities (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard.[14]

[3] Reasonable Cause or Acting in Good Faith

Section 6664(c)(1) provides no penalty will be imposed under Section 6662 for an underpayment if there was reasonable cause and the taxpayer acted in good faith. Thus, where a return position does not satisfy the substantial authority or reasonable basis standard, the taxpayer may avoid the penalty for negligence or disregard of rules by meeting the reasonable cause and good faith exception.[15]

Generally, the most important factor is the taxpayer's effort to determine the proper tax liability. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer. An isolated computational or transcriptional error generally is not inconsistent with reasonable cause and good faith. Reliance on an information return, professional advice, or other facts, however, constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith.[16]

§ 4.04 Cases involving Proposed Penalty Assessments

[1] Reasonable Cause and Good Faith

In *McGowen v. Commissioner*,[17] financial analyst Julie McGowen suffered emotional distress caused by a coworker who harassed her. She received a settlement of $125,000 from her employer consisting of $39,750 for attorney fees, $42,625 for lost income while absent from work, and $42,625 for physical injury caused by emotional distress. On her income tax return, she improperly excluded the payment for emotional distress. Her emotional distress was not a physical injury or physical sickness and the funds were not used to pay for medical care. The accuracy-related penalty under Section 6662 relating to the underpayment was not imposed since the individual demonstrated that there was reasonable cause for the underpayment. The taxpayer lacked knowledge and experience in the tax law and she reasonably believed that the portion of the settlement that she did not report as income was not taxable.

[2] Substantial Underpayment

In *Lindsey v. Commissioner*,[18] taxpayer Paul Lindsey claimed that a company violated an agreement with him and received a payment of $2,000,000 "…allocated to Mr. Lindsey, as the controlling shareholder of EGC, in settlement of his claims for tortious interference with contracts,

[14] Treas Reg § 1.6662-3(b)(3).
[15] Treas Reg § 1.6662-3(b)(3).
[16] Treas Reg § 1.6664-4(b).
[17] TC Memo 2011-186.
[18] TC Memo 2001-113.

for personal injury including injury to Mr. Lindsey's personal and professional reputation and emotional distress, humiliation and embarrassment resulting from termination of the Synergy…”. Lindsey excluded the payment from income, arguing that he suffered physical injury and that the payment was compensation for the injury. The court found that even if Lindsey could prove that he suffered physical injury, there would be no exclusion, because such injury was never claimed during the negotiations for the payment. The court found that the payment was includible in income. The understatement was substantial because it was greater than $5,000 and greater than 10 percent of the tax required to be shown on the return, therefore that the 20 percent accuracy-related penalty of $145,051 applied. Taxpayer could have avoided the penalty by showing that he acted with reasonable cause and in good faith, but he failed to do so. He did not show that he had attempted to determine the strength of the authority on which the exclusion was based, and did not identify any tax professionals on whom he relied.

[3] Gross Overstatement of Basis

In *Rovakat, LLC v. Commissioner*,[19] the taxpayer invested in a tax-shelter transaction which generated superficial Federal income tax losses greater than the economic outlay of the taxpayer. As the first step in the transaction, a foreign entity transferred built-in loss property with its purportedly high basis and a low fair market value (distressed assets) to a domestic partnership in exchange for an interest in the partnership. Second, the foreign entity sold a significant portion of its interest in the partnership to a U.S. taxpayer. Then, the partnership disposed of the distressed assets to formally trigger the built-in losses, with those “losses” allocated to the U.S. taxpayer to offset the taxpayer's unrelated income otherwise subject to Federal income tax. In this case, a series of transactions resulted in Rovakat, LLC owning francs with a value of $34,185 and a purported basis of $5,805,000. The court found that Rovakat effectively spent over $382,000 to produce an economic gain of less than $1,300 and a reportable tax loss in excess of $5 million. The court concluded from the record that Rovakat's basis in the francs was $34,185 because the francs transaction should be classified as a sale,[20] or, alternatively, that the basis was zero because the francs transaction lacked economic substance. Rovakat's basis in the francs as reported on its returns exceeded 400 percent of the basis that Rovakat actually had. The 40 percent accuracy-related penalty under Section 6662(a) was applicable on account of a gross valuation misstatement.[21]

[4] Economic Substance

In *Historic Boardwalk Hall, LLC v. Commissioner*,[22] Pitney Bowes invested about $20 million for a 99.9 percent interest in a limited liability company, treated as a partnership for tax purposes. The other owner was an agency of the State of New Jersey. The partnership funded the renovation of Historic Boardwalk Hall. The partnership tax return reported about $109 million of rehabilitation expenditures. Section 47 allows a Federal tax credit of 20 percent of the qualified rehabilitation expenditures with respect to any certified historic structure. As a partner, Pitney Bowes was entitled to a preferred return of three percent of its investment and the flow-through of rehabilitation credits. The IRS issued a final partnership administrative adjustment (FPAA), claiming that the LLC was a sham and lacked economic substance. The IRS denied Pitney Bowes the benefit of the rehabilitation credits and sought to impose the accuracy-related penalty under Section 6662. The Tax Court found that the venture had economic substance and that the other IRS determinations were incorrect. Since no tax adjustment was required, there was no understatement of tax and no accuracy-related penalty.

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[19] TC Memo 2011-225.
[20] See IRC § 1012.
[21] See IRC § 6662(e).
[22] 136 TC 1 (2011).

§4.05 Guidelines for Avoiding the Penalties

As noted above, there has been an increase in penalties for individual taxpayers from $325 million in 2005 to $1 billion in 2010. There has also been dramatic increase in the amount of penalties abated, from $62,388,000 to $241,645,000. When the IRS determines that a penalty should be applied, the taxpayer or advisor may be able to get the penalty reduced or eliminated.

1) When faced with an accuracy-related penalty, the first line of defense is to prove that the tax return is accurate, and there is no understatement of tax. If there is no understatement of tax, there is no accuracy-related penalty.[23] Use care when preparing a tax return to assure that exclusions, deductions, credits and other positions are supported by the tax law.

2) Many taxpayers are denied deductions because they do not have the documentation that is required to support a deduction or other position taken on the return. Maintaining documentation should have a high priority.

3) When a loss deduction is at issue for an individual taxpayer, it is important for the taxpayer to demonstrate that the loss was incurred in a business transaction, a transaction entered into for profit, or an event giving rise to a casualty loss, as required by Section 165(c).[24]

4) A taxpayer may avoid the penalty by showing that the understatement does not meet the substantial threshold, i.e. 10 percent of correct amount of tax or $5,000. In some cases, winning the argument for one position (e.g., deduction of one expense at issue) will reduce the amount of the underpayment below the threshold and eliminate the penalty.[25]

5) Another defense involves legal authority for the position taken on the tax return. The understatement on which the penalty is based can be reduced by showing that the taxpayer had substantial authority for the position taken, or that there was a reasonable basis for the position taken and the relevant facts affecting the item's tax treatment were disclosed on the tax return. Remember that substantial authority may be present even though the position has less than a 50 percent chance of being sustained upon audit.

6) Taxpayers who made a sincere effort to file a correct tax return can often show that they had reasonable cause and acted in good faith. This requires maintenance of adequate records, care in determining the applicable tax law, care in entering data from information returns, and careful review of the tax return for accuracy and completeness before filing.

7) A taxpayer who has paid additional tax and an accuracy-related penalty may file a claim for refund with the IRS, and file suit in a Federal court if the IRS denies the claim. However, it is important for the taxpayer to properly file a claim for refund with the IRS as a first step. Section 7422(a) provides that no suit or proceeding will be maintained in any court for recovery of any tax until a claim for refund or credit has been duly filed with the IRS. Failure

[23] See Historic Boardwalk case, *supra* note 22.
[24] See Tom Gonzalez, 2011-1 USTC ¶50,280 (Mar. 4, 2011)
[25] In Bangura v Comm'r, TC Summary Opinion 2011-23, the court found that the IRS was correct to reconstruct the income of a CPA who failed to keep records, but found an error in the IRS report that resulted in an overstatement of income. The court upheld the imposition of the penalty for substantial understatement, but held that the amount of the penalty would be determined in the Rule 155 computations, where the IRS error would be corrected – changing the amount of the underpayment and the amount of the related penalty.

to file a timely refund will prevent the taxpayer from getting relief in a court action, because the claim will be barred by the statute of limitations. [26]

8) Stacking of penalties is not permitted. For example, if a portion of an underpayment of tax required to be shown on a return is attributable both to negligence and a substantial understatement of income tax, the maximum accuracy-related penalty is 20 percent of such portion. Similarly, the maximum accuracy-related penalty imposed on any portion of an underpayment that is attributable both to negligence and a gross valuation misstatement is 40 percent of such portion.[27]

[26] See Tom Gonzalez, 2011-1 USTC ¶50,280 (Mar 4, 2011).

[27] Treas Reg § 1.6662-2(c). In Charles L Garavaglia v Comm'r, TC Memo 2001-228, the IRS sought to impose an accuracy-related penalty on the wife for and a fraud penalty on the husband, for the same amount of deficiency. This constituted impermissible stacking of penalties.

Susan C. Hughes on Federal and State Approaches to Resolving Nexus Issues

By Susan C. Hughes, Lexis® Federal Tax Analyst

§ 5.01 Introduction

In the current business environment, multijurisdictional taxpayers are faced with a number of significant state tax challenges, the most fundamental of which is a determination of when their business activities subject them to tax in a particular jurisdiction, or when a state is able to establish that there is sufficient connection between the state and the taxpayer to justify the imposition of a particular tax. Over the years, as the economy has presented additional challenges for the states, changing concepts of nexus have become more useful as a vehicle for raising additional revenue.

At its most basic point, nexus refers to the simple relationship between a taxpayer and the taxing jurisdiction. At one time, nexus was determined primarily with respect to the physical presence of a taxpayer in a particular state; however, the increase in multistate transactions and the advent of electronic transactions conducted over the internet have changed the rules of the nexus game. With the expansion of state theories as to when a particular taxpayer has conducted sufficient activities to satisfy nexus standards, some jurisdictions have taken to adopting theories that, where a taxpayer engages in regular and continuous exploitation of an economic market, whether alone or in conjunction with other entities, the taxpayer will be subject to tax in that particular jurisdiction, regardless of whether the taxpayer has physical presence in the state on its own. These expanding concepts of nexus affect taxpayers in almost every area of taxation, most especially income tax, business activities tax, and sales and use taxes.

In addition to the establishment of nexus based on the activities of the single taxpayer, the concept of nexus extends to the creation of a relationship based on affiliated businesses, or businesses acting as agents on behalf of the taxpayer. Because of the increasing popularity of agency and affiliate nexus, in determining the factors that could lead to a determination that there is presence sufficient to establish nexus, states examine not only the physical or economic presence of the primary taxpayer, but all parent and subsidiary relationships and even more distant relations with other entities that do have nexus with the state. Not only agency relationships are explored, but any relationship in which the primary taxpayer derives a significant economic benefit from the relationship and through which their relationship transactions generate substantial revenue in the state.

Because of the increasing complexity of nexus determinations, and the variety of approaches taken by the states, question has arisen as to whether the federal government needs to step in to create uniformity regarding this subject. Whenever the issue of federal legislation arises with respect to state taxation, there is always a delicate balance that must be maintained between the need for uniformity and the sovereign rights of the states to enact provisions that based on their own state needs. Thus, despite the fact that several attempts have been made in recent years to introduce legislation that would affect nexus determinations, particularly those affecting business activity tax nexus and remote seller nexus, those attempts have been largely unsuccessful. The federal approaches, however, may have served to generate discussion among the states themselves, particularly in multistate venues such as the Multistate Tax Commission, to address these issues. Regardless of whether the issues are ultimately resolved on a federal or state level, it seems clear at the moment that the debate as to the appropriate standards to be applied will continue for a long while to come.

§ 5.02 Traditional and Evolving Nexus Concepts

[1] Constitutional Considerations

To a certain extent, the states have traditionally been limited in their ability to impose tax on businesses with which they have no relationship by U.S. and state constitutional provisions, state statutes and regulations, federal law, and judicial precedent. While this standard seems fairly straightforward, it is in the interpretation of the applicable constitutional and legislative provisions, and judicial determinations, that the nexus waters become murky.

Among the more intriguing and malleable provisions on which nexus determinations are often made are the Due Process and Commerce Clauses of the U.S. Constitution. Judicial interpretations of what satisfies the requirements for nexus in light of these provisions have varied widely.

[a] Due Process clause

The Due Process clause under the 14th Amendment of the U.S. Constitution provides that no state may deprive any person of property without due process of law. Because the imposition of tax deprives taxpayers of their property; therefore, procedural and substantive due process principles apply to state taxation.

Laws governing nexus must fulfill the Due Process requirements of the U.S. Constitution in order to be held constitutionally valid. Constitutional challenges based on due process considerations may be either based on substantive due process, in which the rationale for imposing the tax is questioned, and matters of procedural due process, in which the manner in which the tax is imposed is at issue.

To comply with the due process requirements, two criteria must be met:

1) There must be a minimal connection between the subject of the tax and the taxing state; and
2) There must be a "rational relationship between the income attributed to the state and the intrastate values of the enterprise." [1]

[b] Commerce clause

In order to be constitutional, the laws governing nexus must also meet the challenges of the Commerce Clause. The intent of that clause is to ensure that the laws of a state do not unjustly impinge on the exercise of interstate commerce; that is, that the laws do not create an unjust burden on that commerce. The U.S. Supreme Court, in *Quill* held that the Commerce Clause calls for more than minimum contacts; it requires "substantial" nexus with the taxing state. [2] The substantial nexus standard is directed at ensuring that a state's tax does not unduly burden interstate commerce; hence, the Commerce Clause anticipates a stricter nexus standard than the Due Process Clause. The Court then concluded that the physical presence mandate of *Bellas Hess* was consistent with the Commerce Clause "substantial nexus" standard. [3] North Dakota's attempt to apply its use tax to Quill, therefore, violated the Commerce Clause.

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[1] Mobil Oil Co v Commissioner of Taxes, 445 US 425, 436-437 (1980).
[2] 504 US at 315, relying on *Complete Auto Transit, Inc v Brady*, 430 US 274 (1977).
[3] 504 US 311.

While the satisfaction of the Commerce Clause standard is met ensures that the due process minimum contacts is also satisfied, the satisfaction of due process does not necessarily satisfy the commerce clause standard.

There are those practitioners that believe that the underlying reason that the Court distinguished nexus under the Due Process Clause and the Commerce Clause is that Congress has the authority to legislate under the Commerce Clause, but not under the Due Process Clause. Thus, Congress can remedy any problem that might exist with the physical presence standard with respect to the Commerce Clause, but not due process. [4]

[2] Physical Presence

Traditionally, one of the most basic considerations for establishing nexus was the physical presence of a taxpayer in a state. This has been especially true in the area of sales and use tax since the 1992 U.S. Supreme Court decision in *Quill v. North Dakota*.[5]

One of the more recent developments in the area of nexus, however, has been a shift from nexus based on physical presence to a theory of economic nexus, in which the taxable contact is established based on the taxpayer's exploitation of the economic market in the state. Economic nexus is particularly important in the areas of income/business activity tax law and sales and use tax law. The advent of economic nexus as a standard has changed the way in which the states and the business community looked at their tax relationships. While the concept of physical presence worked to some extent with tangible personal property, and even to the delivery of services, the evolution of remote transactions, from mail order catalogs to online shopping and affiliates, caused confusion among the states, and increased administrative burdens on the states and compliance burdens in the business community. In many situations, the states were called upon to revise their statutory definitions to reflect the modern economic environment. One area in which this is reflected is that of the tax treatment of digital goods and services. To some extent, the state solutions for dealing with these products and services are as varied as they are complex. [6]

[3] Nexus Questionnaires

Over the past couple of decades, the states have become increasingly more aggressive in asserting nexus. Significant budget deficits have caused many states to look at areas in which they can maximize the revenues that are coming in to the state. One area to which they have looked recently has been that of uncollected taxes that are, or even may be, due from businesses outside the state that are registered with the Secretary of State but have not filed corporate income or franchise tax, or sales and use tax, returns.

One method that has increased in popularity in determining the existence of nexus is the nexus questionnaire, by which states can obtain the necessary factual information regarding the extent of a taxpayer's economic activity in the state. One of the most popular methods is the nexus questionnaire.[7] The questionnaire has become a source of information, separate and apart from filed returns, particularly in those situations where nexus is not clearly established, sent to a taxpayer as part of an audit process. Nexus questionnaires are typically sent by taxing authorities as a result of

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[4] See, eg, Arthur P. Rosen and Matthew P. Hedstrom, *Quill--Stare at the Decision*, 2011 STT 123-2 (June 27, 2011).
[5] Quill Corp **v** North Dakota, 504 US 298, 112 SCt 1904 (1992).
[6] For more on economic nexus, see § 5.03[2].
[7] See, for example, New Jersey nexus questionnaire, http://www.state.nj.us/treasury/taxation/pdf/other_forms/misc/nexus_survey.pdf.

shared information with the Secretary of State's office, review of transactions conducted in the state, or even audits of other taxpayers with which the questionnaire recipient has done business.

Although the nexus questionnaire is a complex document, seeking information on all of the business' transactions in the state, it is imperative that the business pay strict attention to the information that it is furnishing to the state. Failure to consider all of the potential ramifications of the responses can lead to costly results. A 2010 Michigan Court of Appeals case[8] is indicative of the hazards inherent in responding to a nexus questionnaire that is sent by the state. In the *Barr Laboratories* case, the taxpayer corporation had received two nexus questionnaires from the state covering periods between 1989 and 2004. The taxpayer completed the questionnaire, believing that Public Law 86-272 applied to the Single Business Tax, which was then in effect.[9] The responses of the taxpayer to the nexus questionnaire resulted in a determination on the part of the state that the taxpayer was subject to its tax provisions, and led to considerable litigation.

While nexus questionnaires will often appear to be harmless surveys, the potential ramifications of a taxpayer's answers can be devastating and extremely difficult to overcome. Furthermore, the responses are often the only piece of information that state tax authorities consider in deciding whether to conduct a full scale audit of a taxpayer's business. For these reasons, taxpayers should always seek counsel of tax professionals before attempting to respond to such questionnaires.

Typically, the nexus questionnaire will include identifying information about the taxpayer, and will go on to explore relationships and transactions, including the following:

- Any agents, independent contractors, subcontractors, third parties, and others who worked on the company's behalf in the state;
- Location of books and records, and whether there is any management and control in the state;
- Any affiliated or related entities with business activities in the state, with detailed description of intercompany transactions;
- Involvement as a general or limited partner in a partnership or corporation doing business in the state.

The questionnaire will then go on to explore business activities conducted in the state, in relation to business activities everywhere. The nexus questionnaire examines the company's revenue streams and the activities and the sources of that revenue.

§ 5.03 Corporate Income Tax

[1] Public Law 86-272 and its limitations

For more than 50 years, nexus for purposes of the imposition of corporate income taxes has been limited by federal legislation, known as Public Law, or P.L. 86-272. [10] Although it is unclear as to the extent to which P.L. 86-272 to taxes other than those taxes, there is no question as to its definitive applicability to corporate income taxes (taxes based on net income). An area of uncertainty exists, however, where a tax that is generally characterized as an income tax is actually a

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[8] Barr Labs v Dep't of Treasury, 2010 Mich App LEXIS 2033 (Mich Ct App Oct. 21, 2010).

[9] Note that the Single Business Tax was later replaced by the Michigan Business Tax, for which PL 86-272 applied only to the income tax component. Effective January 1, 2012, the Michigan Business Tax has been replaced by a straight corporate income tax, for which Public Law 86-272 does apply.

[10] 15 USCS § 381, enacted on September 14, 1959.

tax that is composed of multiple components, which include a tax on net income and some other tax base or bases. Examples of this type of tax include the Texas margins tax (franchise tax)[11] and the now-repealed Michigan Business Tax.[12]

For those situations to which the federal law does apply, P.L. 86-272 provides that no state or political subdivision may impose a tax based on net income on any person if the taxpayer's only business activities in the state during the taxable year consist of:

1) solicitation of orders by the taxpayer or a representative of the person in the state, for sales of tangible personal property, under which the orders are sent out of state for approval or rejection, and for approved orders, are filled by shipment or delivery from a point outside the State; and/or

2) solicitation of orders by the taxpayer or a representative in the state in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders that are previously described above.

Under the terms of P.L. 86-272, the limitation applies only to out-of-state taxpayers; it does not apply to taxpayers that are domiciled or reside in the state. For purposes of the application of P.L. 86-272, a taxpayer is not considered to have engaged in business activities within a state merely as a result of sales or solicitation of orders for sales by independent contractors, or because an independent contractor conducting solicitation activities on behalf of the taxpayer maintains an office in the state. Independent contractors include commission agents, brokers, and others engaged in similar activities.[13]

Although the state's ability to subject taxpayers to net income taxes is limited somewhat by P.L. 86-272, the enactment of that federal law more than 50 years ago, does not take into consideration the changing face of corporate taxation. With more of a focus on business activity taxes replacing or supplementing net income taxes, the nexus limitation imposed by P.L. 86-272 has been substantially eroded in many situations. The changing tax environment has also given rise to the doctrine of attributional nexus, through which a taxpayer can be found to have nexus because of its relationship with another entity.

[2] Economic Nexus

The U.S. Supreme Court, in *Geoffrey v. South Carolina Department of Revenue and Taxation*,[14] upheld the position of the South Carolina court that the presence of intangibles established substantial economic nexus sufficient for the imposition of state corporate income taxes. The Court found that the "minimum contacts" test was satisfied due to the purposeful activity by Geoffrey toward the state of South Carolina and the location of Geoffrey's intangible property, in the form of licensed trademarks and know-how, within the state. The South Carolina Court also held that the Commerce Clause's substantial nexus requirement was satisfied. Since *Geoffrey,* the courts have seemed to be satisfied with using economic presence as a test when determining the existence of nexus.[15]

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[11] Tex Tax Code Ann § 171.001(a).
[12] Mich Comp Laws § 208.1105(1).
[13] Enacted Sept. 14, 1959, PL 86-272, Title I, § 101, 73 Stat 555.
[14] 510 US 992, 114 S Ct 550, 126 L Ed 2d 451, 1993 US LEXIS 7349, 62 USLW 3375 (1993).
[15] See, eg, Commr v MBNA America Bank, NA, 220 W Va 163 (Sept 19, 2006), the West Virginia Supreme Court upheld the taxation to MBNA's credit card revenues earned in West Virginia. And in KFC Corp v Iowa Dept of Rev, 181

States that have statutorily adopted an economic nexus standard include:

1. Arkansas [16]
2. Connecticut[17]
3. Florida [18]
4. Indiana [19]
5. Iowa [20]
6. Louisiana [21]
7. Maryland [22]
8. Massachusetts [23]
9. Minnesota [24]
10. New Jersey [25]
11. New Mexico [26]
12. North Carolina [27]
13. Oklahoma [28]
14. Oregon [29]
15. South Carolina [30]
16. Wisconsin [31]

§ 5.04 Business Activity Taxes

Public Law (P.L.) 86-272 provides a basic standard for the imposition of business taxes that are based on net income; however, the past couple of decades have seen a transition on the part of many states a business activity tax, either as a standalone or in conjunction with its corporate income tax. For those states that have adopted taxes that with alternative bases, such as gross receipts, the applicability of P.L. 86-272 is not nearly as clear. While the federal law may apply to the net income component, it may not safeguard the out-of-state business from taxation based on other criteria.

Several states, including California,[32] Delaware,[33] Hawaii,[34] Kentucky,[35] New Jersey,[36] and New Mexico,[37] have adopted gross receipts taxes.[38] Other states, such as Ohio[39] (with the

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L Ed 2d 26 (Oct 3, 2011), the Iowa Supreme Court affirmed the imposition of Iowa's income tax on franchise fees received by KFC from independent franchises operating in Iowa.
[16] Ark Regs 1996-3.
[17] Conn Gen Stat § 12-216a.
[18] Fla Admin Code § 12C-1.01(1)(p).
[19] Letter of Finding, No 95-040 1 (June 1, 2002).
[20] KFC Corp v Dept of Rev, 792 NW2d 308 (Iowa 2010) ; 701 Iowa Admin Code 52.1 (422).
[21] Bridges v Geoffrey, 984 So2d 115 (La App 2008) .
[22] Comptroller v SYL, 825 A2d 399 (Md Ct App 2003).
[23] Capital One Bank v Comm'r, 899 NE2d 76 (Mass 2009).
[24] Minn Stat § 290.0 15.
[25] Lanco, Inc v Director, Div of Tax, 908 A2d 176 (NJ 2006), *cert denied*, 551 US 1131 (2007); 18 NJ Admin Code § 7-1.9(b).
[26] Kmart Prop, Inc v Tax & Rev Dept, 131 P3d 27 (NM Ct App 2001) , rev'd as to gross receipts tax and writ quashed as to income tax, 131 P3d 22 (2005).
[27] A&F Trademarks, Inc v Tolson, 605 SE2d 187 (NC Ct App 2004) ; NC Gen Stat § 105-130.7A.
[28] Geoffrey, Inc v Oklahoma Tax Cornrnr, 132 P3d 632 (Okla Civ App 2005); Okla Admin Code § 710: 50-17-3(a)(9).
[29] Or Admin Code R 150-318.020(2).
[30] Geoffrey, Inc v South Carolina, 437 S.E.2d 13 , *cert denied*, 510 US 992 (1993) ; Rev Rul 9-83 (1998) .
[31] Wis Reg Tax § 2.82(4)(a)(9).
[32] California
[33] Delaware

commercial activity tax, or CAT), Texas[40] (with the corporate franchise, or margins, tax), and Washington [41](with its business & occupations tax) have adopted some measure of composite tax. Until recently, another tax that was based in part on gross receipts was the Michigan Business Tax (MBT), which was recently replaced, effective January 1, 2012, with a straightforward and more easily managed corporate income tax.

A taxpayer has asked the U.S. Supreme Court whether the *Quill* physical-presence nexus standard applies to non-sales and use taxes, such as the Washington business and occupation (B&O) tax and, if so, whether such a physical presence was established by two or three visits per year by sales employees to existing customers in Washington.[42] The taxpayer is a New Jersey manufacturer of insulation and vapor barriers with no permanent offices or agents in Washington. Two or three times a year during the tax period at issue, three of the company's sales employees visited major customers in Washington. During these visits, the employees did not solicit sales directly, but they answered questions and provided information about the company's products.

The taxpayer challenged Washington's assessment of B&O tax, arguing that it did not have a substantial nexus with the state. The Washington Supreme Court rejected this challenge, holding that the taxpayer's practice of sending sales representatives to meet with its customers within Washington was significantly associated with its ability to establish and maintain its market. The court noted that there is language in *Quill*, 504 U.S. 298 (1992), suggesting that the physical presence requirement should be restricted to sales and use taxes. However, it added that, to the extent there is a physical presence requirement outside the sales and use tax context, it can be satisfied by the presence of activities within the state that are substantial and associated with the company's ability to establish and maintain its market within the state. [43]

Although the issue of nexus with respect to net income taxes has remained somewhat settled for the past half century as a result of federal P.L. 86-272, limiting the extent to which states can tax businesses with only limited activities in a state, the issue becomes murkier when other taxes, such as those based on business activity, are taken into consideration. In an attempt to clarify the applicability, over the past few years federal legislation has been introduced to modify the terms of P.L. 86-272 to account for business activity taxes, most recently in the 2011 Congressional session.[44] The legislation, known as the Business Activity Tax Simplification Act (BATSA), would expand the current prohibition of state net income taxes to the imposition of business activity taxes on taxpayers who did not have physical presence in the state for at least 15 days during the tax year. The legislation would further expand protected activities under P.L. 86-272 to include information gathering and dissemination along with protected solicitation activities, could prove costly for many states that have attempted to expand their own definitions of nexus.

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[34] Hawaii
[35] Kentucky
[36] New Jersey
[37] New Mexico
[38] Gross receipts taxes
[39] Ohio
[40] Tex Tax Code Ann § 171.001(a).
[41] Wash Rev Code § 82.04.010.
[42] Lamtec Corp v Dep't of Revenue, 151 Wn App 451, 215 P3d 968, 2009 Wash App LEXIS 1956 (2009), 168 Wn2d 1009; 226 P3d 782; 2010 Wash LEXIS 157, affirmed 170 Wn2d 838, 246 P2d 788, 2011 Wash LEXIS 77 (2011), US Supreme Court, Dkt 10-1289, petition for certiorari filed April 19, 2011.
[43] *Id*.
[44] The most recent BATSA legislation, as introduced in the 2011 legislative session was introduced as HR 1439.

This is not to say that the federal legislation will be successful in the near future; BATSA has been introduced in every legislative session since 2003. With the exception of the addition of a *Joyce* rule, based on a California case which provides that the denominator of a combined group's apportionment formula must include the aggregate factors of every member of a combined group, and the numerator includes only those factors of members of the combined group that are subject to tax in the state, the legislation is substantially similar to the earlier introduced pieces of legislation that have been rejected in the past.

Although the BATSA legislation seems to make sense in many ways, in that it would provide a definitive standard that would apply across the board in the state tax arena, there are several impediments that stand in the way of its enactment. One of the chief impediments to the BATSA, and a significant factor in the defeat of the legislation in the past, is the vocal opposition that it has generated from the National Governors' Association, which represents the interests of the states (or at least the state executives).[45] While some of the NGA's opposition, which dates back to the legislation that was originally proposed in 2003, is based primarily on state sovereignty, that opposition also includes administrative and practical considerations as well. As state coffers have run down, the imposition of an economic nexus standard has helped refill those coffers with additional revenues from out-of-state businesses. The BATSA would result in a serious loss of revenue for many states that have begun to depend on that additional revenue to try to close budget gaps.

The main argument advanced by proponents of the legislation is that, with the widening reach of the Worldwide Web, and a global economy making it virtually impossible to have a purely "local" business, it has become almost imperative that a new standard be provided to establish some measure of consistency in the area of nexus. According to its supporters, the legislation would go a long way towards protecting multistate taxpayers from overreaching on the part of states with which a business may have only limited connections.

Federal legislation has received some support in the financial community. The American Bankers Association (ABA) has issued a position statement supporting BATSA legislation. According to the position statement, the ABA support is premised on the need for physical presence nexus to exist. The ABA's position statement indicates that, as the focus of the economy has increasingly shifted from sales of tangible personal property to delivery of services and intangible personal property, the need for clarification has increased in importance. Noting that the concept of nexus as physical presence has been upheld in judicial precedent, the ABA expressed its support for the federal legislation that would establish the physical nexus standard and prohibit state and local governments from imposing any business activity tax on a business unless that business has a physical presence in the state or locality that meets specified standards.[46]

Even with the support of various communities, the likelihood of passage of the BATSA in the near future seems remote. Opposition to the legislation, primarily on behalf of the states, remains strong. Also, while the physical presence standard does provide some measure of certainty, it creates a large number of gaps through which transactions can fall, resulting in even more significant losses of revenue to the states. All in all, however, while the BATSA legislation may be flawed in some respects, it does provide another opportunity for open and honest debate about the issue.

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[45] See, for example, http://www.nga.org/cms/home/federal-relations/nga-letters/executive-committee-letters/col2-content/main-content-list/august-4-2011-letter---business.html, letter from the National Governor's Association.
[46] See http:/www.aba.com/Issues/Issues_Business Activity.htm.

§ 5.05 Sales and Use Taxes

[1] Physical Presence Under *Quill*

With respect to sales and use taxes, limitations have been imposed to some extent based on the U.S. Constitution and several U.S. Supreme Court cases interpreting the constitutional requirements to establish nexus. In determining the existence of nexus for sales and use tax purposes, it is probably the historical landmark decision in *Quill Corp. vs. North Dakota*[47], that has been *the* defining judicial determination in setting forth a general nexus standard, at least for sales and use tax purposes. In *Quill*, the U.S. Supreme Court held that, in order for a sales tax to be valid under the commerce clause, a taxpayer must have physical presence in the state to be subject to tax. While *Quill* has been the accepted standard in the states for sales tax nexus over the past couple of decades, the states have argued that *Quill* is limited to sales and use taxes; thus, physical presence is not required in the state income and business activity tax area. The issue of physical presence, however, has been substantially revisited in recent years, in light of the changing face of multistate sales transactions.[48]

[2] Attributional and Agency Nexus

It is important to note that businesses can have nexus, not only through their own activities, but also those of their affiliates and agency relationships. U.S. Supreme Court cases have expanded attributional nexus to taxes other than sales and use taxes. See the following cases, for example, which show the extension of attributional nexus to business taxes:

1) *Tyler Pipe Industries, Inc. v. Washington State Department of Revenue*,[49] where significant in-state activities were sufficient to create constitutional nexus for Washington's Business and Occupation tax, for an out-of-state principal, and

2) *In the Matter of the Protest of Dart Industries Inc.*, [50] and *Reader's Digest Ass'n. v. Franchise Tax Board*,[51] regarding the protection of P.L. 86-272 denied as a result of activities of affiliates and third party distributors.

[3] Remote Sellers

With the advent and increased usage of the internet for commercial transactions, the issue of nexus has become more complex than ever. Because of the upswing in internet transactions, and particularly sales conducted across the electronic borders, the federal government and state governments find themselves in difficult waters is the extent to which there should be a uniform standard for determining the collection responsibility of online retailers for sales and use tax purposes. The topic took on a whole new life in 2008, when New York state took on electronic retailers with respect to their collection responsibilities for online sales transactions conducted with in-state customers.

Back in 2008, New York created a maelstrom when it took steps to definitively address the issue of the collection and remittance responsibilities of electronic retailers, by its enactment of a law based on the affiliate relationships of the electronic retailers that generated sales in the state. The law

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[47] 504 US 298 (1992).
[48] For more on the physical presence requirement, see Bender's State Taxation: Principles and Practice, § 12.03.
[49] 483 US 232 (1987).
[50] New Mexico Taxation and Revenue Department, No 04-03, (2004).
[51] 94 Cal App 4th 1240 (2001), *reh'g denied*, 2002 Cal LEXIS 1786.

became known as the "Amazon Tax Law," [52] focusing on the fact that Amazon.com is probably the single largest electronic retailer affected by the law. As enacted in 2008, New York's Amazon tax law requires online retailers with more than $10,000 in gross receipts from sales to in-state customers through relationships with in-state affiliates to collect sales tax on those transactions, the states have had to evaluate the extent to which they want to impose that requirement. The enactment of this law generated considerable controversy, and no sooner had the law been enacted than it generated litigation as well.[53] In addition to filing suit to preclude the state from imposing its nexus standard based on these relationships, Amazon (and Overstock.com) threatened to sever affiliate relationships in those states in which such legislation had been passed.[54] Over the past few years, the issue has been addressed in several states, sometimes resulting in a virtual ping-pong match between the state and the retailers. The Amazon tax laws focus on what is known as "click through" nexus, by which nexus with electronic retailers is established by the process of internet sales.

Among the states that have enacted Amazon tax laws since 2008 are: Arkansas,[55] California,[56] Colorado,[57] Connecticut,[58] Illinois,[59] New York,[60] North Carolina,[61] Rhode Island,[62] South Dakota,[63] and Tennessee.[64] More recently, in 2012, similar legislation has been introduced in Florida and Indiana.[65]

While many of the states continue to debate the imposition of Amazon tax laws, or to engage in separate negotiations with online retailers,[66] California has reached a point of holding the issue in abeyance. Although a California law subjecting certain remote sellers to California collection and remittance obligations[67] was enacted, the law was later repealed, with its effect being dependent on whether federal legislation is enacted dealing with the issue.[68] As part of a deal in force with the California government, Amazon agreed to begin collecting sales taxes under the California law on September 15, 2012, if there was no federal legislation in place by July 31, 2012.[69] The situation in California, in particular, has generated a strong call for the federal government to act to adopt national rules governing online sales tax collection mandates. The push for federal legislation seems to have strong support from both online and brick-and-mortar retailers.[70]

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[52] NY Tax Law §1101(b)(8)(vi).
[53] Amazon.com, LLC v New York State Dept of Tax'n & Fin, 913 NYS2d 129 (2010).
[54] Amazon threatened to sever affiliate relationships in certain states, including California and Massachusetts. See, for example, *Amazon.com Threatens to Cut Ties With California Affiliates Over Tax Issue,* by Nick Turner, Bloomberg News, http://www.bloomberg.com/news/2011-03-02/amazon-com-threatens-to-sever-ties-with-california-affiliates.html, March 2, 2011, and *Online retail sales cause Massachusetts to miss out on an estimated $300 million-plus in tax revenue,* by Jon Chesto, The Patriot Ledger, April 4, 2011.
[55] Ark Code Ann §26-52-117(d)(1); L 2011 1001 §2.
[56] Cal Rev & Tax Code § 6203(c)(5)(A).
[57] Colo Rev Stat § 39-26-102(3)(b)(II).
[58] Conn Gen Stat §12-407(a)(12) ; Conn Gen Stat §12-407(a)(15).
[59] ILCS Chapter 35 §105/2(1.1).
[60] NY Tax Law §1101(b)(8)(vi).
[61] NC Gen Stat §105-164.8(b)(3).
[62] RI Gen Laws §44-18-15(a).
[63] L 2011 S146 §2.
[64] Tenn Code Ann § 67-6-210.
[65] Florida, SB 1352, filed on December 22, 2011 and Indiana, SB 100, pre-filed on December 28, 2011.
[66] See, eg, http://indianaeconomicdigest.com/Main.asp?SectionID=31&SubSectionID=119&ArticleID=63423 for details of agreement.
[67] AB 155, as amended.
[68] *Id*.
[69] See http://www.leginfo.ca.gov/pub/11-12/bill/asm/ab_0151-0200/ab_155_bill_20110909_amended_sen_v95.html, for full text.
[70] *Brown Signs Bill to Repeal 'Amazon' Law, Retailers Vow to Push for Federal Rules,* by Laura Mahoney, 186 DTR H-4 (2011).

On the federal level, Congress has taken a variety of approaches to establishing uniformity in the area of the sales tax collection and remittance obligations of remote sellers. The bills that have been introduced in Congress to address the issue in 2011 have included the Main Street Fairness Act,[71] the Marketplace Equity Act, [72] and the Marketplace Fairness Act. [73]

The Main Street Fairness Act was originally introduced in Congress in 2010 but died in committee. Congress decided to try revisiting the issue in 2011, however, when the battle between the states and the online retailers seemed to take on a life of its own. Under the terms of the Main Street Fairness bills as introduced, Congress would have the right to facilitate equal taxation of similar remote sales transactions regardless of the method of delivery, whether by mail, telephone, or electronic delivery methods.

Some practitioners have expressed the belief that, of the bills that have been introduced in Congress, the Market Place Equity Act of 2011[74] is the most likely to generate the support that would allow for its passage. This legislation would authorize states to compel out-of-state vendors to collect sales and use taxes if the state created a remote seller return, which required filing no more frequently than in-state retailers; maintained a uniform tax base; and used either a blended (state and local) tax rate, a single maximum rate for state and local taxes, or a destination rate (the rate imposed at the site of the customer's location). Remote sellers with total remote sales of less than $1 million in U.S. sales or with less than $100,000 in a particular state would be exempt from collection responsibility.

In the meantime, the issue of whether to subject electronic retailers with affiliate in-state relationships to sales tax collection responsibility has been a subject of intense debate in many of the states themselves. While Congress does have the authority to legislate with respect to the states' tax collection responsibilities, considerable discussion has been generated as to whether the federal government should act in such a situation. Thus, in an attempt to preclude federal action that would pre-empt state determination, several states have taken it upon themselves to attempt to solidify their thinking as to the extent to which remote sellers, particularly electronic retailers, are engaged in taxable activities in the state.

One means of creating a measure of uniformity among the states, by which the states themselves agree to a certain standard is with the provisions of the Streamlined Sales and Use Tax Agreement (SSUTA).[75] Under the SSUTA, member states request that remote sellers voluntarily collect sales taxes on items purchased by customers outside their home state. Vendors in participating states who voluntarily collect the sales tax would be offered amnesty for previously uncollected taxes. Participating states have agreed to share the administrative burden of collecting taxes to ease tax collection for sellers.

§ 5.06 Peripheral Issues—Withholding Across State Borders

In addition to the nexus considerations and their effect on the taxation of a particular business, there are a myriad of related issued that are peripheral to nexus. One such peripheral issue is that of determining when there is a sufficient relationship between an entity's employees and the taxing jurisdiction to impose a withholding obligation on the business for the income earned by

[71] S 1452, H.R. 2701, introduced July 29, 2011.
[72] HR 3179, introduced Oct 13, 2011.
[73] S 1832, introduced Nov 9, 2011.
[74] HR 3179, introduced in 2011.
[75] SSUTA, http://www.streamlinedsalestax.org/index.php?page=modules.

nonresidents of the state in which they are employed. Because states vary widely in their approaches, and *de minimis* exemption periods, the ability of a business to comply with the withholding tax laws in a particular state is often cumbersome, particularly for businesses that have operations in several states. As a result of the wide disparity in these laws, federal legislation has been proposed that would set the standard for determining when a nonresident employee's earnings would be subject to state income tax and when the business would be required to withhold. Under the provisions of the proposed federal legislation,[76] known as the Mobile Workforce State Income Tax Simplification Act, an employee's earnings would be subject to state income tax and withholding if the employee performed work in the state for more than 30 days during the calendar year.

The current law in many states requires that employers withhold state income tax from an employee's income as soon as the employee starts earning income in the state. Some states do provide for a *de minimis* exception, but this is by no means an across the board situation. If adopted, the Act would exempt employers from the withholding tax requirement for nonresident employees if three criteria are met: (1) the nonresident employee has no other income that is sourced to the nonresident taxing state; (2) the nonresident employee spends fewer than 20 days in the taxing state during the tax year; and (3) the nonresident employee's state of residence provides a similar exception to the withholding requirements.

The Act provides that a business may rely on the employee's determination of the amount of time that he or she expects to work in the state in which the duties are performed for the employer. This reliance is appropriate, even if the employer maintains its own records of where the employees are located for business purposes. A recommendation is made, however, that where an employer keeps its own records of the location of employees' work activities, the time and attendance system used by the employer would be the most accurate determinant of the employee's location, and should be used instead of the employee's estimations. There are two circumstances in which an employer may not rely on the employee's representation: (1) where the employer has actual knowledge of fraud by the employee, and (2) where there is a collusive attempt by the employer and employee to evade the tax.

Under the terms of the legislation, employees would be considered to have worked in a particular state on a given day if the "preponderance" of the employee's duties took place in that state. If employees divide their time between a resident state and a nonresident state, the employee is deemed to have performed the majority of their duties in the nonresident state. Commuting time is not included in the computation of time for purposes of this legislation.

Because professional athletes and entertainers, who are paid on a per-event basis, are not generally treated the same as other employees, those individuals are not covered by the provisions of the legislation.[77]

While the need for uniformity in the area of taxing nonresidents performing work in the state on a limited basis is a compelling concern for many businesses, and the need for simplification of reporting and compliance has been discussed in many circles, the approach that should be taken to creating that uniformity has been the subject of much debate. Although federal legislation has its defenders, there are also those who are reluctant to subject state issues such as this to federal control. In an attempt to deal with the issue on a state level, and thus eliminate the need for federal action, the Multistate Tax Commission (MTC) has adopted a model Mobile

[76] Mobile Workforce State Income Tax Simplification Act, HR 1864.
[77] *Id*.

Workforce Statute at its annual meeting at the beginning of 2011.[78] The intent of the adoption was to provide a working model for states to use to simplify the law surrounding employer withholding obligations. Currently, most states require employers to withhold state income tax from employee compensation (even in the amount of a single dollar), regardless of whether the employee works in the state for one day or one year. The model mobile workforce statute provides a measure of relief from the withholding obligation where an employer has employees who are not residents of the taxing state who are present in the state fewer than 20 work days during the tax year. Employees with no income that is attributable to the taxing state need not file or pay tax to the taxing state.

In November of 2011, the American Institute of Certified Public Accountants (AICPA) advocated that the Mobile Workforce State Income Tax Simplification Act be passed allowing employees to work in a nonresident state for up to 30 days before being subjected to state income tax, with the employer being required to withhold.[79] Among other considerations, the AICPA's support for the legislation is premised on its position that the current situation in which the state income tax laws vary and there are different *de minimis* standard, create an overly complex compliance mechanism for many businesses, including a significant number of its own member accountants have employees working for clients periodically in states other than their own resident state.

The states themselves have also approached the situation with a model Mobile Workforce Withholding and Individual Income Tax Statute proposed by the Multistate Tax Commission (MTC) in June of 2010.[80] Despite some concerns by its members that the proposal undermines the principle of taxing income at its source, the MTC voted, at its annual business meeting, to adopt the language of the proposed mobile workforce statute. While virtually every state belongs to the MTC, an intergovernmental agency that advocates on behalf of uniform provisions enacted by the states themselves, the agency does not have the authority to implement legislation in the various states. It can, however, support endeavors by individual states to enact such provisions. As noted by some members of the MTC, if the states can agree on a common solution to the problem, that agreement can help to preclude federal action on the issue, which would preempt the states from addressing similar concerns.[81] North Dakota already has enacted legislation similar to the model statute approved by the MTC.[82]

Unlike the federal legislation, which provides for a 30-day *de minimis* period, the MTC uniform model statute provides for a 20-day *de minimis* period.[83]

§ 5.07 Conclusion

As can readily been seen, while nexus is a simple term, it becomes more complex in its actual application, particularly in an economic environment in which many, if not most, transactions are conducted across state borders, and often involve intangible as well as tangible elements. When many of the traditional nexus concepts were established, there was very little that could not be fitted into a reasonably simple box. The location of tangible personal property could generally be traced from state to state, and the presence of property or payroll in a particular state could readily be ascertained. As the marketplace began to reflect move of a move to multistate transactions and

[78] Multistate Tax Commission, www.mtc.gov.
[79] AICPA, November 2011.
[80] Multistate Tax Commission, www.mtc.gov.
[81] *Id*.
[82] North Dakota SB 2170, Laws 2011.
[83] www.mtc.gov.

electronic commerce, many of the traditional concepts either became irrelevant or needed to be explored and adapting to fit the changing needs of the marketplace. While considerable debate can take place as to whether solutions to nexus uncertainty should take place on a federal or state level, it is clear that some action is needed to ensure that taxpayers and states are on the same page as to what constitutes nexus. The standardization of nexus application can help to avoid considerable expense on the part of the states to seek out taxpayers who are not in compliance, and to help taxpayers avoid difficulties when they are uncertain as to what their compliance responsibilities are.

Multistate businesses face significant challenges when navigating the choppy waters of state tax laws, regulations, rulings, and judicial decisions regarding nexus can be difficult, if not impossible, with which to keep pace. The following checklist can provide a starting point by which practitioners can start to determine whether there is a possibility that the taxpayer will be subject to nexus. Although not an exclusive listing of considerations, it does address many of the major issues with which the state taxing authorities are concerned when making their nexus determinations.

Nexus Checklist

____ Carefully examine the types of taxes imposed in the state for which the nexus determinations are to be made, and the applicability or inapplicability of the physical presence standard or economic presence in determining nexus. Review the relevant statutory and case law, as well as any implementing regulations in the particular state to determine what the appropriate standard is.

____ Ascertain the extent to which any property or personnel, or affiliate relationships in the state, can subject you to taxation. Identify the location of tangible personal property, and review the laws and regulations governing intangible property and the delivery of services. Determine the extent to which any independent contractors, telecommuting employees, sales representatives, or other multistate work situations (regional sales reps, trade shows, etc.) that may establish nexus in the state. Because of the varied approaches by states, it is important to note the applicable standard used by the state.

____Review the nature of all transactions conducted with customers in the state. For example, a transaction that is composed of several steps may look as though it took place outside the taxing state, but one or more steps in the transaction may be sufficient to place the transaction (and the taxpayer) within the boundaries of the state.

_____ Review administrative and collection responsibilities, and carefully review entries on nexus questionnaires. Sometimes inaccurate responses to queries on nexus questionnaires can subject a taxpayer to questions regarding nexus, even if nexus is not ultimately established. If there is any question as to whether nexus exists, filing a questionnaire and filing any required returns may be the best alternative, since that will start the limitations period. Failure to file can leave you in a vulnerable position since any resulting examination can result in significant tax liabilities, penalties and interest.

Current Developments

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§ 6.01 ACCOUNTING

Rev Rul 2012-1,
2012-2 IRB 1

IRS Issues Guidance on Recurring Item Exception to All Events Test

Synopsis: The IRS has issued guidance clarifying the treatment of some liabilities under the IRC Section 461(h)(3) recurring item exception to the economic performance requirement of the all events test.

Revenue Ruling 2012-1 clarifies the "not material" and "better matching" requirements in the context of a one-year lease liability and a one-year service contract liability. In the ruling, a corporation entered into a lease agreement from July 1 through June 30, 2012, for property it will use in its trade or business to generate income over the period of the lease. The corporation also entered into a service contract with a maintenance company for the same period to provide services related to the leased property. The corporation's financial statements account for the lease agreement and service contract by recognizing, ratably over the one-year period, a one-time payment on July 1, for each liability.

The IRS determined that for purposes of the recurring item exception, the lease liability is material and does not satisfy the matching requirement because the accrual of the lease liability over more than one tax year results in better matching of the liability with related income. Thus, the corporation cannot use the recurring item exception to treat its lease liability as incurred in 2011. The IRS also found that the corporation's service contract liability arises out of the provision of services rather than arising out of the provision of a warranty or service contract. Because the corporation's service contract liability is material and it does not satisfy the better matching requirement, the IRS ruled that the recurring item exception does not apply to the corporation's service contract liability.

§ 6.02 BACKUP WITHHOLDING

Notice 2011-88
2011-46 IRB 748

IRS Postpones Effective Date of Backup Withholding on Payment Card, Third-Party Network Transactions

Synopsis: The IRS has postponed for one year the effective date for potential backup withholding obligations for payments made in settlement of payment card and third-party network transactions.

IRC Section 3406 imposes potential backup withholding obligations for payments made in settlement of payment card and third party network transactions. Information returns are required to be made by certain payors with respect to payments made in settlement of payment card transactions and third party payment network transactions. [IRC § 6050W]

The Treasury Regulations under IRC Section 3406 require that backup withholding apply to payments made after December 31, 2011, if a payee has not furnished a correct taxpayer identification number to an IRC Section 6050W payor. The IRS has postponed for one year the requirement to apply backup withholding. Specifically, the backup withholding requirements of IRC Section 3406 will apply only to payments made after December 31, 2012.

§ 6.03 BUSINESS ENTITIES

Final Treasury Regulations, TD 9553

IRS Publishes Final Regulations on Disregarded Entities and Excise Taxes

Synopsis: The IRS has published final treasury regulations clarifying that a single-owner eligible entity that is disregarded as an entity separate from its owner for any purpose, but is regarded as a separate entity for some excise tax purposes, will be treated as a corporation for issues related to the excise taxes.

Generally, a business entity that has a single owner and is not a corporation is disregarded as an entity separate from its owner. [Treas Reg § 26 CFR 301.7701-2(c)(2)(i)] The finalized regulations provide that an entity that is disregarded as separate from its owner under Treas Reg Section 301.7701-2(c) is treated as an entity separate from its owner for purposes of: (1) Federal tax liabilities of the entity with respect to any taxable period for which the entity was not disregarded; (2) Federal tax liabilities of any other entity for which the entity is liable; and (3) Refunds or credits of Federal tax. [Treas Reg § 26 CFR 301.7701-2(c)(2)(iii)] Further, an entity that is disregarded as an entity separate from its owner is treated as a corporation with respect to taxes imposed under Subtitle C--Employment Taxes and Collection of Income Tax. [Treas Reg § 301.7701-2(c)(2)(iv)(B)]

Final Treasury Regulations, TD 9560

IRS Publishes Final Regulations on New Markets Tax Credit and Targeted Populations

Synopsis: The IRS has published final treasury regulations on how an entity meets the requirements to be a qualified active low-income community business when its activities involve targeted populations under IRC Section 45D(e)(2).

The American Jobs Creation Act of 2004 (Pub L No 108-357) amended IRC Section 45D(e)(2) to allow the Secretary to prescribe regulations under which one or more targeted populations may be treated as low-income communities. As a result of the promulgation of final regulations, Notice 2006-60 is obsolete. The final regulations provide that an entity will not be treated as a qualified active low-income community business for low-income targeted populations unless at least 50 percent of the entity's total gross income for any tax year is derived from sales, rentals, services, or other transactions with individuals who are low-income individuals for purposes of IRC Section 45D(e)(2); at least 40 percent of the entity's employees are low-income individuals; or at least 50 percent of the entity is owned by low-income individuals. The final regulations also clarify that the three-year active conduct of a trade or business safe harbor in section 1.45D-1(d)(4)(iv)(A) does not apply to the 50-percent gross-income requirement.

The final regulations lock in an owner's status as a low-income individual as of the time the qualified low-income community investment is made or when the ownership interest is acquired by the owner, whichever is later. Further, an entity whose sole business is the rental to others of real property is treated as satisfying the 50 percent gross-income requirement if the entity is treated as being located in a low-income community.

§ 6.04 EMPLOYMENT

Notice 2011-86,
2011-45 IRB 698

IRS Issues Guidance on User Fee for Employee Plan Determination Letters

Synopsis: The IRS has provided guidance on the IRC Section 7528(b)(2) exemption from the requirement to pay a user fee for some applications for determination letters on the qualified status of pension, profit-sharing, stock bonus, annuity, and employee stock ownership plans. The guidance explains how to determine if an application has been filed within a remedial amendment period beginning within the plan's first five plan years.

IRC Section 7528(b)(2) provides for exemption from the requirement to pay a user fee for certain applications to the Service for determination letters on the qualified status of pension, profit-sharing, stock bonus, annuity, and employee stock ownership (ESOP) plans.
To qualify for the exemption the pension, profit-sharing, stock bonus, annuity, or ESOP plan must be maintained solely by one or more eligible employers (within the meaning of IRC Section 7528(b)(2)(C)(ii)) and the application must be filed by the later of the last day of the fifth plan year the plan is in existence or the last day of any remedial amendment period with respect to the plan beginning within the first five plan years. [IRC § 7528(b)(2)(B) and (C)]

To simplify the process for determining if the application was timely filed the Service will treat an application as having been filed by the last day of a remedial amendment period with respect to the plan beginning within the first five plan years if both of the following conditions are met: (1) the application is filed with the Service by the last day of the submission period for the plan's current remedial amendment cycle, and (2) the plan is first in existence no earlier than January 1 of the tenth calendar year immediately preceding the year in which the submission period for the plan's current remedial amendment cycle begins. This rule is generally applicable to all applications for determination letters that are filed with the Service after January 31, 2011.

Notice 2011-96,
2011-52 IRB 915

Single-Employer Plans Funding-Based Limits

Synopsis: The IRS has issued guidance that provides a sample plan amendment that plan sponsors may adopt to satisfy IRC Section 436 regarding limitations on the accrual and payment of benefits under some underfunded single-employer defined benefit plans.

Single employer defined benefit plan are subject to the minimum funding requirements of IRC Section 412. [IRC § 401(a)(29)] Benefit plans subject to IRC Section 412 must meet the requirements of IRC Section 436. IRC Section 436 sets forth limitations on the accrual and payment of benefits under an underfunded plan.

Notice 2011-96 provides a sample amendment which plan sponsors can rely on to satisfy the requirements of IRC Section 436. The amendment is divided into three parts. The first part contains provisions applicable to all plans. The second contains two alternative provisions, one of which must be adopted with the first part of the sample amendment in the case of a multiple employer plan. The third part consists of four optional provisions that may be used to modify the first part of the sample amendment.

This notice also extends both the deadline to amend a plan to satisfy IRC Section 436 and the period during which such an amendment is eligible for relief from the anti-cutback requirements of IRC Section 411(d)(6).

§ 6.05 PARTNERSHIPS

The Heritage Organization, LLC, et al v Commissioner
TC Memo 2011-246

Tax Court Denies Partnership's claimed Research, Business Expense Deductions

Synopsis: The Tax Court, upholding accuracy-related penalties, held that payments a partnership made to controlled corporations in a Son-of-BOSS transaction did not qualify as research expenses under IRC Section 174 or as ordinary and necessary business expenses under IRC Section 162 and did not result in constructive dividends to a partner.

The taxpayer developed a strategy to create trust basis through a contingent liability transaction and create built-in losses in the trusts. The taxpayer planned to sell the trusts to clients that could gain tax benefits from the built-in losses. As part of the plan, 11 dormant corporations were transferred to 11 trusts. The taxpayer lent funds to each corporation that were payable on demand with interest on a specific date. On the tax returns, the taxpayer characterized the payoff amounts as research and development expenses. The taxpayer argued that the payoff amounts were expenses used to develop corporations with embedded. The Court determined that the payoff amounts failed to meet the IRC Section 174 requirement that the expenditures be for research in the experimental or laboratory sense because the payments were not made for scientific activities. Further, the payoff amounts did not qualify as research and development expenses because they were not incurred to eliminate uncertainty concerning the development of a product.

The taxpayer also argued that the payoffs were deductible under IRC Section 162 as ordinary and necessary business expenses. The court found that the taxpayer's business involved estate planning and issuance of life insurance and not not selling "off the shelf" entities with embedded losses. The payments were reimbursements for the resulting losses rather than ordinary and necessary business expenses.

The court also rejected the Commissioner's argument that the payoff amounts should be recharacterized as constructive dividends to a partner. The IRC Section 6662(a) penalty was imposed, as the taxpayer did not act reasonably or in good faith.

Russian Recovery Fund Ltd v United States
2011 US Claims LEXIS 2172

Claims Court Holds Losses on Later Year Return Attributable to Losses Disallowed on Prior Year FPAA.

Synopsis: The Court of Federal Claims held that issuance of a final partnership administrative adjustment suspended the assessment limitations period for an indirect partner who filed a return for a different year in the three-year period prior to the FPAA's issuance because losses on the partner's return were attributable to losses disallowed in the FPAA.

The taxpayer, a partnership, sought readjustment of partnership items. The taxpayer alleged that the IRS's issuance of a Final Partnership Administrative Adjustment (FPAA) for the tax year ending December 31, 2000, was untimely and therefore invalid, and that the representative partners' 2000 and 2001 tax years were closed for adjustment and assessment. In addressing the timeliness issue, the court determined that the issue was whether the period for assessment has expired. After reviewing IRC Section 6501, which requires the IRS to assess all taxes within three years of the taxpayer's filing of his individual return and IRC Section 6229, which deals specifically with partnership items, the court found that the FPAA was timely as to one of the representative partners in the motion. IRC Section 6229 did not create a separate statute of limitations for issuance of an FPAA.

Proposed Treasury Regulations, 76 FR 72875
REG-109369-10

Treasury Releases Material Participation Guidance

Synopsis: The IRS released proposed regulations regarding the definition of an "interest in a limited partnership as a limited partner" for determining whether a taxpayer materially participates in an activity for purposes of the passive activity loss rules under IRC Section 469.

Under the proposed regulations, an interest in an entity would be treated as an interest in a limited partnership under IRC Section 469(h)(2) if two conditions are met. First, the entity must be classified as a partnership for federal income tax purposes under Treas Reg Section 301.7701-3. Second, the holder of the interest must not have rights "to manage the entity at all times during the entity's taxable year under the law of the jurisdiction in which the entity was organized and under the governing agreement." [76 FR 72875, Preamble] The proposed regulations also include rules regarding limited partnership interests in rental real estate activities under Treas Reg Section 1.469-9(f).

§ 6.06 REAL ESTATE

Notice 2012-5,
2012-3 IRB 1

Safe Harbor Method for Reporting REMIC Assets

Synopsis: The IRS has provided a safe harbor reporting method that an eligible real estate mortgage investment conduit may use to report REMIC assets to residual interest holders. The safe harbor method applies to reporting for calendar quarters ending on or after December 31, 2011.

A REMIC must provide REMIC asset information on Schedule Q each quarter to anyone who held a residual interest in the REMIC during that quarter. The information must include the percentage of REMIC assets described in IRC Section 7701(a)(19) (Category 1); and (2) the percentage of REMIC assets that are real estate assets defined in IRC section 856(c)(5)(B) (Category 2), computed by reference to the average adjusted basis (as defined in IRC Section 1011) of the REMIC assets during the calendar quarter. If the percentage of Category 1 or Category 2 REMIC assets is at least 95 percent, the REMIC need only specify that the percentage for that category was at least 95 percent on Schedule Q. The REMIC must provide additional information if, for calendar quarters after 1988, the 95 percent asset-reporting test is not met for Category 2 assets.

The REMIC regulations generally treat a mortgage loan as an obligation "principally secured by an interest in real property" for purposes of IRC Section 860G(a)(3) if the loan is secured by an interest in real property that is worth at least 80 percent of the outstanding stated principal of the loan. If, however, a REMIC holds one or more qualified mortgages that are less than 95 percent secured by an interest in real property, the REMIC may fail the 95 percent asset-reporting test and may be required to report additional information to residual interest holders on the REMIC assets.

Notice 2012-5 provides a safe harbor reporting method. An eligible REMIC with either Category 1 or Category 2 assets of less than 95 percent but at least 80 percent need only specify on Schedule Q that the percentage for that category was at least 80 percent. To qualify as an eligible REMIC, under the safe harbor, (1) the REMIC must have a guarantee from Fannie Mae or Freddie Mac that will supplement amounts received by the REMIC as required to permit the payment of principal and interest, as applicable, on both the regular interests and residual interests issued by the REMIC; and (2) all the qualified mortgages that are held by the REMIC must be secured by interests in single-family (one-to-four-unit) dwellings.

Rev Proc 2012-14,
2012-3 IRB 1

Safe Harbor for REITS Investing in some REMIC Interests

Synopsis: The IRS has issued guidance with a safe harbor that provides the extent to which investments by a real estate investment trust in a regular or a residual interest in some real estate mortgage investment conduits are qualifying investments and generate qualifying income for REIT purposes under IRC Section 856(c).

This revenue procedure applies to a regular interest that is held by a REIT in an eligible REMIC as defined in Notice 2012-5 and to a residual interest that is held by a REIT in an eligible REMIC as defined in Notice 2012-5, if, in accordance with Notice 2012-5, the REMIC informs the REIT holding the residual interest in that REMIC that the percentage of the REMIC's assets described in IRC Section 856(c)(5)(B) was at least 80 percent.

Under Rev Proc 2012-14, a qualifying REIT may treat 80 percent of the value of the regular or residual interest as a real estate asset. If the REIT can show that as a result of holding the interest, its proportionate share of the eligible REMIC's assets under IRC Section 856(c)(5)(E) produces a higher percentage for purposes of IRC Section 856(c)(4)(A), then the REIT may use that higher percentage. Any amount includable by the REIT in gross income for the regular or residual interest may be treated as 80 percent derived from interest on an obligation secured by a mortgage on real property under IRC Section 856(c)(3)(B). If the REIT can show that as a result of holding the interest, its proportionate share of the eligible REMIC's income under IRC Section 856(c)(5)(E) produces a higher percentage for purposes of section 856(c)(3), then the REIT may use that higher percentage. The safe harbor is effective for regular or residual interests in an eligible REMIC that has a start-up date after November 30, 2011.

§ 6.07 SECURITIES

Proposed Treasury Regulations, 76 FR 72652
REG-102988-11

Basis Reporting by Securities Brokers and Basis Determination for Debt Instruments and Options

Synopsis: The IRS has published proposed regulations on information reporting by brokers for transactions related to debt instruments and options, noting changes to the reporting requirements for transactions involving all covered securities, including stock.

IRC Section 6045 was amended by the Energy Improvement and Extension Act of 2008 [Pub L No 110-343, § 403], to require the reporting of adjusted basis for a covered security and whether any gain or loss upon the sale of the security is long-term or short-term. The Act also requires the reporting of gross proceeds for an option that is a covered security. In addition, the Act added IRC Section 6045A, which requires certain information to be reported in connection with a transfer of a covered security to another broker, and IRC Section 6045B, which requires an issuer of a specified security to file a return relating to certain actions that affect the basis of the security.

The proposed regulations amend Treas Reg Sections 1.6045-1, 1.6045A-1, and 1.6045B-1 to require additional information reporting by a broker for a debt instrument acquired on or after January 1, 2013 and require information reporting for an option granted or acquired on or after January 1, 2013. The proposed regulations incorporate debt instruments and options into the rules established for stock in the final treasury regulations published in TD 9504 and thus the general rules of Treas Reg Section 1.6045-1 that currently apply to stock also will apply to a debt instrument or an option that is a covered security, including the wash sale and short sale provisions. Also, the general rules of Treas Reg Section 1.6045A-1 relating to transfer statement requirements and Treas Reg Section 1.6045B-1 relating to issuer statement requirements will apply to a debt instrument or an option. The proposed regulations also include other changes necessary to accommodate debt instruments and options.

Temporary Treasury Regulations, TD 9561

IRS Publishes Temporary Regulations on Treatment of Tips Issued with more than De Minims Premium Amount

Synopsis: The IRS has published temporary regulations requiring taxpayers to use the coupon bond method described in Treas Reg Section 1.1275-7(d) for Treasury inflation-protected securities issued with more than a de minimis amount of premium

The temporary regulations incorporate the rules set forth in Notice 2011-21. Under the temporary regulations, a taxpayer must use the coupon bond method described in IRC Section 1.1275-7(d) for a Treasury Inflation-Protected Security that is issued with more than a de minimis amount of premium. The temporary regulations contain an example of how to apply the coupon bond method to a Treasury Inflation-Protected Security issued with more than a de minimis amount of premium. The temporary regulations apply to securities issued on or after April 8, 2011.

§ 6.08 TAX-EXEMPT BONDS

Notice 2012-3,

Current Refundings of Tax-exempt Bonds in Certain Disaster Relief Bond Programs

Synopsis: The IRS has issued guidance on current refunding issues, as defined in Treas Reg Section 1.150-1(d)(3), that refund outstanding prior issues of bonds that qualify for tax-exempt bond financing under some disaster relief bond programs.

Notice 2012-3 applies only to tax-exempt bonds issued as qualified Gulf Opportunity Zone Bonds under IRC Section 1400N; qualified Midwestern disaster area bonds under the Heartland Disaster Tax Relief Act of 2008; and qualified Hurricane Ike disaster area bonds under the Heartland Disaster Act. The statutory provisions for these qualified bonds are silent on the permissibility of current refundings of these bonds after the applicable bond issuance deadlines. Thus, the IRS has provided that a current refunding issue that meets the specific requirements set forth in the notice may be issued after the specified deadline for the issuance of the original qualified bonds and be treated as an issue of qualified bonds. For those current refunding issues, a designation of the original qualified bonds by a specified state or local governmental official, or a state bond commission that meets the applicable designation requirement, is treated as meeting the designation requirement for the current refunding issue without further designation or further official state or local governmental action.