TAX TALK

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From the Chair

By Andrea B. Gillespie

There was a time when I could answer a simple tax question without first spending hours researching the topic. That was a long time ago. Now, in order to answer the most basic question, I must pull a reference book, and then another and another, and then call someone. According to my children, it's because I just turned fifty. They may be right. On the other hand, it could be because the tax code has grown out of control.

Once, I knew and respected tax practitioners who could correctly answer basic tax questions, right off the top of their heads. Now, I believe that anyone attempting this trick is crazy and obviously does not have the proper respect for, or fear of, the code.

I have become a tax attorney who avoids giving tax advice. How does one comfortably give advice when a transaction can be treated differently under multiple provisions of the Internal Revenue Code, not least of which is the Alternative Minimum Tax and the Maryland Code? That's for this year. Of course, everything will change next year, so don't plan too far in advance.

Although the size of the federal tax code is a worthy discussion topic, my intended subject for this commentary is closer to home, the expanding Maryland tax code. Originally, the Maryland tax code was limited to addressing those taxes exclusive to Maryland, such as Maryland sales tax. This is no longer the case. Like their federal counterparts, Maryland legislators are using the tax code to assist in solving social and economic problems. Actually there are sound reasons for this tinkering, including the need to increase revenue, and the desire to reward certain economic or social behavior. Examples of such legislative solution making can be found every year in the long list of tax bills submitted by members of the General Assembly. We are now averaging one hundred tax bills a session.

However, enough is enough. Even though only a few of these are enacted into law, the number is sufficient to raise concern over a growing trend. Specifically, whether the intended benefits generated by these tax laws are worth their cost to our tax system. Included in my definition of our tax system is the cost to the Comptroller's Office in staff hours to process these changes such as updating its forms and instructing the public. Included in this annually increasing cost are: (i) wear and tear on tax practitioners (always an important subject); (ii) cost to taxpayers whose accountants must now keep three or four different sets of books; and (iii) inability to make long term financial and business plans. These costs are hidden but can have just as great a monetary impact as those financial variables analyzed in the fiscal notes attached to each bill.

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Mark Your Calendars!

The Annual Irving Shulbank Memorial Diner and Program

Thursday, May 18, 2006 at
The Camden Club, Oriole Park at Camden Yards

6:30 p.m. - Cocktails 7:15 - Dinner

8:00 – Presentation of: The 2005 Tax Excellence Award
The J.Ronald Shiff Memorial Pro Bono Award

8:15 – Program - Distinguished Speaker to be announced soon

Please watch for the sign-up flyer announcing the speaker and the menu.

Blanton Case Raises Further Questions on Non-Resident Tax

By: Jeffrey A. Markowitz and Rebecca G. del Carmen
Miles & Stockbridge

In 2004, the State of Maryland began imposing a tax on non-residents equal to the lowest county income tax rate in effect in any Maryland county. This tax is collected by the state; no county shares in any portion of the revenue. Federal constitutional law prohibits the imposition by any state of discriminatory taxes on non-residents; in essence, no state tax may place a non-resident at a relative economic disadvantage by virtue of their non-residency. While the State of Maryland views the additional non-resident tax as constitutional, many practitioners have questioned whether the tax unconstitutionally discriminates against non-residents. Presumably, the argument for its constitutionality rests on notion that, *taken as a whole*, the State income tax imposed on a resident is at least equal to the State income tax imposed on a non-resident, but only if you include the county income tax imposed on residents in the calculation.

On January 12, 2006, the Court of Appeals of Maryland issued a decision that may raise further challenges to the constitutionality of the additional non-resident tax. In *Comptroller of the Treasury v. Edward L. Blanton, Jr., et al.*, the Court of Appeals held that a tax credit for out-of-state taxes may be applied to reduce the amount of a Maryland resident's State income tax liability, but not its local income tax liability. The decision is based on the Court's conclusion that the State income tax is a separate and distinct tax from local county taxes. This, however, seems incompatible with the above argument as to the additional non-resident tax's constitutionality. If the State income tax is separate and distinct, then the non-resident tax, as part of the State income tax, is an *additional tax on non-residents* that is not imposed on Maryland residents. There is already a case in Maryland Tax Court brought on behalf of Saul Ewing's non-resident partners challenging the non-resident additional tax.

CALLING FOR NOMINATIONS FOR THE TAX EXCELLENCE AWARD

The Tax Section seeks nominations for candidates for the 2006 Tax Excellence Award. The Tax Excellence Award is presented annually to an attorney, law school professor, public official or member of the judiciary who exemplifies professional, academic or public service excellence, integrity, compassion, and commitment in the areas of practicing, teaching, or developing tax law or tax policy.

If you know an individual who should be considered, please email Bryan Young, Chair of this year's Awards Committee, at byoung@bwylaw.com, with your recommendation as well as a brief statement as to why you feel the suggested person is worthy of consideration. Please submit nominations by March 6, 2006.

From The Chair...

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There is no easy solution. It is difficult arguing against bills that benefit those benefitting society. But the tax savings provided by most of these bills is usually nominal. Meanwhile their cost in terms of additional records and bookkeeping, not to mention general confusion, is skyrocketing. No one doubts that these bills are well intentioned, but does this justify the fact that there are so many exceptions to so many rules that no one can prepare his or her own taxes without the help of a computer program?

Now, I am not asking for a moratorium on the enactment of new Maryland tax laws. I do request, however, that tax legislation be subjected to a meaningful and realistic cost benefit review while it is in committee. This review would consider the value of the intended benefit and its real cost in terms of Comptroller's Office paperwork and staff hours.

That said, there is one piece of tax legislation that I would support, a law limiting the size of the Tax-General Article to one book. That's it, only one book, and no tiny type.

With that out of my system, I will move on to an update on Tax Section activities. Todd Bornstein did another wonderful job planning and coordinating the Advanced Tax Institute. As usual, it was a great success. If you attended one of this year's courses, and have comments or suggestions for improvements, please be sure to either email your comments to Todd or the Council. I also wish to thank Katrina Kamantauskas-Holder and Bryan Young for their excellent work on Tax Networking Night. We had a great turnout, the food and location was terrific and I had a wonderful time. Last, but not least, I wish to thank Brian L. Oliner for all of his hard work on this publication and his unending patience with me.

Please note on your calendar that this year's Shulbank Dinner is scheduled for May 18, 2006 at Camden Yards. At this event we will again be presenting the Tax Excellence Award to a distinguished practitioner who has displayed superior tax expertise and a commitment to improving the field of taxation. Also at this year's Shulbank Dinner, for the first time, we will be presenting the J. Ronald Shiff Pro Bono Award to a tax practitioner or firm that exhibits the same commitment to assisting those less fortunate through pro bono tax services, as did Ron. We are currently requesting nominations from the tax community for both of these awards. More detailed information listing the suggested qualifications for the awards can be found in this edition along with nomination forms.

Finally, I wish to thank those practitioners that use the Tax Section Listserv. Those with the courage to ask questions and those with the knowledge and generosity to respond to these questions are helping to create a more informed tax community. I hope to see many of you at this year's Shulbank Dinner.

ECONOMIC DEVELOPMENT THROUGH TAX BREAKS: THE FUTURE LIES IN THE NEW SUPREME COURT

By Brian L. Oliner

The vast majority of policy makers believe that a sound tax policy should be neutral to all economic activity, raising revenue with a minimum amount of economic distortion. Such a tax policy should not create incentives for business to engage in one type of activity to the detriment of another. The economists' corollary to this position is that the tax system should be broad-based, with low rates and as simple as practical.

Juxtaposed to these basic tenets is the desire to promote economic development. One tool of economic development, employed at all levels of government and in most jurisdictions, is the targeted tax credit or tax incentive. It is almost universally accepted by economists that such tax credits and incentives narrow the tax base and require other sectors to shoulder a heavier tax burden. Nonetheless, advocates of such programs argue that they are necessary to stay competitive. Furthermore, these advocates believe that competitive pressure and the ballot box will change the tax system for the better. Put more succinctly, the voice of the electorate and normal market pressures will bring the tax system to an acceptable equilibrium.

Within this background one can understand the silent, but palatable apprehension felt by state and local governments, economic development authorities, and business owners because of a case currently pending before the U.S. Supreme Court and legislation pending before Congress. This term the Court will review the matter of *DaimlerChrysler Corp. v. Cuno; Wilkens v. Cuno*. This case comes out of the federal court decision in Cincinnati, striking down a tax incentive given to companies when they purchase new equipment, provided the company expanded its operations in the state. The federal court determined that the credit illegally discriminated against interstate commerce in violation of the "dormant" commerce clause provisions of the U.S. Constitution. As a consequence of this federal court decision, Congress introduced the Economic Development Act of 2005. This act, which is currently in committee, would reverse the effects of the decision and statutorily protect these types of targeted tax credits and incentives.

Opponents of the tax incentive program argued that these incentives illegally tax interstate commerce in violation of the Commerce Clause of the U.S. Constitution. A tax provision can satisfy the Commerce Clause if:

1. The activity taxed has a substantial nexus with the taxing state;
2. The tax is fairly apportioned to reflect the degree of activity occurring in the state;
3. The tax does not discriminate against interstate commerce; and
4. The tax is fairly related to benefits provided by the state.

The opponents of the Ohio tax incentives did not contest points 1, 2 and 4. They also conceded that it is legitimate for the state to use its tax system to encourage new intrastate economic activity (a position the U.S. Supreme Court has previously ruled as non-violative of the Commerce Clause). Rather, the opponents' argument was that Ohio's method for encouraging new investment by granting tax incentives and exemptions discriminated against interstate commerce. Such discrimination exists if, on its face or in its practical application, the credit or exemption provides a direct commercial advantage to local business and burdens out-of-state economic interests.

Per the opponents, the investment tax incentive discriminated against interstate commerce because it coerced businesses subject to the Ohio corporate tax to expand locally rather than out-of-state. Citing a line of previous Supreme Court decisions, the federal court agreed with the opponents and ruled that the Ohio investment tax credit discriminated against interstate commerce because it took what was once a "tax-neutral" business decision and made it one that was now driven by the potential tax consequences.

Citing a fundamental difference between tax credits and exemptions, the federal court did not strike down the property tax exemption. The court noted that a company that purchased new equipment for placement out of state would not be subject to the property tax at all and, thus, any discriminatory treatment between the one who invests in Ohio and the one who invests out-of-state cannot be attributed to the Ohio tax regime.

Opponents of the federal court's decision cite numerous legal flaws and negative impacts that will result. They argue that the decision is overbroad because all state tax policy decisions are contingent on in-state activities. Taking the standard set out in the decision to its logical conclusion, all state tax policy actions and state government activity would be subject to Commerce Clause challenges. Secondly, because the court did not strike down the direct tax exemption for the property tax, the impact to businesses remains the same, i.e. the bottom line. Thus, states will continue to compete using these programs, just changing their stripes. Thirdly, the court seemed to use the fact that Daimler had a pre-existing tax liability as partial justification for its decision. Does this mean the tax incentive would have been upheld if there was no pre-existing tax liability? Why should this make a difference? Fourth, the "tax-neutral" standard is unworkable because nearly every business decision is premised on tax considerations.

Other arguments against the decision include: 1) giving these plaintiffs standing means every taxpayer in the country could potentially have standing to sue almost any major com-

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SECTION OF TAXATION SEEKS NOMINATIONS FOR THE J. RONALD SHIFF MEMORIAL PRO BONO AWARD

The Maryland State Bar Association's Section of Taxation has established an annual pro bono award in memory of **J. Ronald Shiff, Esq.**, a past Chair of the Section Council and a distinguished tax attorney with the firm of Gordon Feinblatt. This annual award recognizes the efforts and dedication of one or more individuals or law firms who have provided meritorious pro bono services in the field of taxation, with special consideration given to those who have represented either low income taxpayers or organizations who serve low-income taxpayers.

The Pro Bono Award Committee is now seeking nominations for candidates for the 2006 **J. Ronald Shiff Memorial Pro Bono Award.** Nominations must be submitted by **March 24, 2006.**

For further information, please contact Robin W. Denick, Esq., Chair of the Pro Bono Award Committee, at (410) 962-3153.

ELIGIBILITY AND CRITERIA FOR SELECTION FOR THE J. RONALD SHIFF MEMORIAL PRO BONO AWARD

Eligibility

- Eligible candidates include individual attorneys or law firms who render legal services to individuals or organizations in Maryland. Individuals who are members of the Tax Section Council or its committees (including those Past Chairs who remain on the Section Council for a period of time as outlined in the Section By-laws) are not eligible for nomination or consideration.

- Candidates must have performed a level of pro bono service that is measurable and within the parameters discussed in the criteria for selection section below. Bar association activities or other activities of a pro bono nature that benefit the profession or the practice of law will not be considered for purposes of this award.

Criteria for consideration and selection

Evaluation of pro bono services rendered include those provided over an extended period of time (not limited to the current year), as well as activities with intensive involvement over a limited time with significant impact:

- Handling a significant number of tax controversies for low-income taxpayers on a pro bono basis

- Voluntarily forming, operating or participating in organizations, such as low-income taxpayer clinics (LITCs) devoted to representation of low-income taxpayers, particularly if such participation is over an extended period

- Formation, supervision and participation in programs to assist taxpayers in the resolution of their tax controversies, including "attorney of the day" programs for the Tax Court

- Mentoring and teaching law students and other individuals who work for LITCs

- Preparation of resource materials for LITCs and other low-income programs

- Providing pro bono legal assistance to IRC section 501(c)(3) tax-exempt organizations, especially those formed to help low-income individuals. Special consideration should be given to those candidates who provide advice on tax matters to such organizations on a pro bono basis

- Providing legal services to individuals affected in periods of national crisis or natural disasters (such as victims or families of victims of terrorist attacks, floods, earthquakes, or hurricanes) or to individuals or family members of those who serve in the armed forces of the United States during war times, with special emphasis on assistance in providing advice on tax matters

- Providing education on tax matters to members of the general public (such as through speaker's forums, etc.), especially to groups consisting of low-income individuals

NOMINATION FORM

J. RONALD SHIFF MEMORIAL PRO BONO AWARD

SECTION OF TAXATION, MARYLAND STATE BAR ASSOCIATION

I/We have considered the eligibility/selection criteria for the above award and wish to nominate:

Name (individual or law firm) ____

____

(if an individual, please also include name of firm; if nominating a law firm please include names of lawyers in firm who worked on the matter/matters giving rise to the nomination)

Address of nominee ____

____

Description of pro bono services provided and what such services accomplished or why they were valuable — please include, where known, the hours of representation provided, the duration of the representation (such as over an extended period of time or intensive involvement over a limited period of time), the type of legal work or activities undertaken by the nominee and, in particular whether the services were provided to an individual low-income taxpayer or an organization that serves low –income individuals), and the significance or impact of such services

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(Use additional paper if necessary)

Reasons why the individual or law firm should be selected to received the Pro Bono Award—(narrative of specific details or achievements are encouraged):

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Submitted by:

Name: ____________________________

Organization or firm name (where applicable)

____

Address: ____________________________________

____

____

phone: _____________________________________

e-mail: _____________________________________

May we contact you to discuss this nomination? _________

Please submit this nomination form by **March 24, 2006** to:

Robin W. Denick, Esq.
Chair, Pro Bono Award Committee
MSBA Section of Taxation
Maryland Bar Center
501 West Fayette Street
Baltimore, MD 21201

CIRCULAR 230: THE IMPORTANCE OF BEING ZEALOUS

By: David Borinsky
Gordon, Feinblatt, Rothman Hoffberger and Hollander, LLC

"Although I may marry others, and marry often," says the heroine, bosom heaving, to her one true love, "nothing can alter my eternal devotion to you."

Which makes perfect sense if you are a tax lawyer. Consider the following:

Gwendolen and Cecily consult Algernon, a tax attorney, about deferring recognition of more than $10 million in gain on the sale of real estate through the use of a Section 1031 like-kind exchange. In addition to the standard Section 1031 issues, they need reassurance that the property being sold was 'held for investment,' as they had not held the land very long before they undertook to subdivide it into lots for the purpose of selling them in bulk to a homebuilder. In addition, Gwendolen wants to reinvest her share of the sales proceeds in replacement investment property, while Cecily wants to purchase an expensive retirement spread where she can try her hand at breeding racehorses. (Algernon, Gwendolen and Cecily and are characters in "The Importance of Being Earnest," a play written by 19th century author Oscar Wilde. Wilde, a celebrated wit, once observed that "it is only by not paying one's bills that one can hope to live in the memory of the commercial class." We shall honor Wilde for his keen insight into the business mind by adapting his characters to a modern business case study.)

In his initial meeting with Gwendolen and Cecily, Algernon discusses the possible difficulty in qualifying the property as held for investment, owing to the short holding period and the subdivision into building lots. In addition, he outlines several improvised and, Algernon notes, uncertain structuring techniques available to deal with the problem of having less than all partners in a partnership electing to reinvest under the like kind exchange rules. He also describes to Cecily, in general terms, the rules relating to hobby losses.

As the meeting concludes, Algernon recaps the issues discussed and recites for his clients his follow-up 'to-do' items. First, he notes that although Gwendolen and Cecily may have a problem meeting the "held for investment" requirement with respect to the relinquished property, he is pretty sure there is at least substantial authority for that position, and he promises a short memo containing a discussion of helpful caselaw. Mindful of his clients' dislike for large professional fees, he promises to keep the time spent on that memo to a minimum, just enough, that is, to protect Gwendolen and Cecily from an accuracy-related penalty.

With respect to the differing reinvestment plans, Algernon suggests redeeming Cecily with a note just prior to closing on the relinquished property. He explains that while no consensus has formed among tax practitioners as to one best, customary commercial practice in this difficult area, his gut tells him that, more likely than not, the presale redemption structure will work for tax purposes. He promises to discuss his assessment with a colleague and then confirm it with Gwendolen and Cecily in a quick e-mail. Gwendolen mentions that, with Algernon's permission, she might forward his email to a real estate colleague wrestling with the same problem.

Finally, with respect to the horse farm, Algernon tells Cecily that there is a large body of the case law on the hobby loss issue, and that the right answer in any given case is fact-sensitive. He agrees to send Cecily copies of some sample cases. Cecily would then report back to Algernon how she plans to conduct her horse breeding business. Implicit in this conversation, which is conducted with a wink and a nod, is that Algernon will coach Cecily to provide him with the "right facts," without regard to what Cecily's horse breeding plans actually are. Whatever the real facts, Algernon thinks to himself, there is little likelihood of an audit. Algernon plans to avoid written advice to the client on this issue.

As the meeting breaks up, Algernon summons his secretary to make copies of his notes for each of Gwendolen and Cicely.

Cut! Tell me what's missing from this script?

"Not much," you sniff. "It's utterly trivial and pedestrian. Gwendolen and Cecily, as real estate developers, display a characteristic sense of entitlement to an exemption from income taxes. Algernon, ever the servant of justice — and aware that Gwendolen and Cecily know every other CPA and tax lawyer in town — eagerly serves up the appropriate, if aggressive, strategy for accomplishing that result."

True, but irrelevant. What's really missing is an appreciation of how recently imposed practice obligations on tax advisors – lawyers and accountants — as well as recent changes in the reporting obligations, have rendered that scene dangerous to the pocketbooks of Gwendolen and Cecily and a threat to the professional good standing of Algernon. A radical shift is underway in the expected role of tax advisors in the fair administration of Federal tax law. As this article will show, Oscar Wilde's love smitten protagonist's claim that "nothing can alter my eternal devotion to you" notwithstanding, Algernon's indiscriminate willingness to serve up every tax dodge demanded by Gwendolen and Cecily's is a conceit of the past, less quaint, but as out of date as the names Wilde chose for the characters in his plays.

Enactment of New Circular 230

Although Treasury Department regulation of tax practitioners, known as Circular 230, dates back many decades, the most recent version of that regula-

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tory scheme became effective on June 20, 2005. It includes the following noteworthy enhancements and additions: best practices; covered opinions (both the definition and when the requirement for issuing a covered opinion arises); procedures to ensure compliance with the covered opinion rules; and rules relating to other written tax advice.

Best Practices

Best practices are aspirational rather than mandatory. The best practices section, Section 10.33, recites a list of practice values akin to those appearing in the Rules of Professional Conduct. The regulations provide that best practices include "advising the client regarding the import of the conclusions reached, including, for example, whether a taxpayer may avoid accuracy-related penalties…if the taxpayer acts in reliance on the advice." So far, so good. Aggressive tax planning necessarily involves, either explicitly or implicitly, a judgment about whether a position can be taken on a return without exposing either the taxpayer or the preparer to penalties.

Circular 230 imposes best practices obligations on law firms and accounting firms. These are discussed in the Respondeat Superior section of this essay.

Covered Opinion

A character in a well known play (not Wilde's) expressed surprise at the discovery that he had been speaking "prose" all his life. With the advent of the new Circular 230, only the meekest of tax advisors will confidently assume that they are not issuing "covered opinions" in the every day course of their practice. Under Section 10.35 of Circular 230, all but the mice among us must cope with the challenge of either complying with or taking conscious steps to avoid having to comply with the covered opinion rules. The covered opinions rules, therefore, complex and cumbersome though they are, bear careful consideration.

A covered opinion consists of *written advice* (electronic communications constitute written advice) concerning one or more "Federal tax issues," provided that the Federal tax issue or issues arise from an enumerated list of categories, as follows: (i) a listed transaction (see, as of the date of this writing, Notice 2004-67); (ii) a marketed opinion; (iii) an entity, plan or arrangement the principal purpose of which is to avoid or evade taxes (a "principal purpose transaction"); or (iv) an entity plan or arrangement which has as a significant purpose to avoid or evade taxes (a "significant purpose transaction").

For the covered opinion rules to apply, moreover, a Federal tax issue must be "significant," meaning that the IRS must have a "reasonable basis" for successfully challenging a taxpayer's position, and the resolution of the controversy would have a "significant impact" on the overall tax treatment of the transaction. (That's three uses of the word significant to keep straight: *significant purpose* transactions, *significant Federal tax issue* and a *significant impact* on the tax treatment of a transaction.)

Issuing a covered opinion is a lot of work and creates a lot of expense for clients, so many if not most tax advisors will attempt to deliver competent, responsible tax advice without triggering the covered opinion rules. Principal purpose transactions *always* trigger the requirement for a covered opinion. Significant purpose transactions, in contrast, *may or may not* call for the issuance of a covered opinion. As discussed below, the "significant purpose" test is a wobbly, uncertain gear in the Circular 230 regulatory scheme.

Significant Purpose versus Principal Purpose

Complying with the intricate new rules of Circular 230 is not only impossible, it is also extremely difficult. The rules are a challenge to understand, and it is impossible to know for sure if you really do understand them. Nowhere is that difficulty more evident than in the linedrawing required to determine if a transaction is a principal purpose transaction or a significant purpose transaction.

As recited above, written advice concerning a principal purpose transaction is *per se* required to be given in the form of a covered opinion. Written advice concerning a plan or transaction having tax avoidance as merely one of its significant purposes, however, need be given in the form of a covered opinion *only* if the written advice is in a "suspect category" (my terminology, not that of Circular 230). A suspect category is one or more of the following: a reliance opinion; a marketed opinion; advice subject to conditions of confidentiality; or advice subject to contractual protection.

The Circular 230 regulations define principal purpose transactions as those with respect to which the tax avoidance or evasion purpose exceeds all other purposes in importance. In contrast to that bland but commonsense definition of principal purpose transactions, Circular 230 does not define significant purpose transactions. Regulations promulgated under the tax shelter rules of Section 6111 provide that a significant purpose transaction is a transaction "structured to produce tax benefits that constitute an *important part of the intended results* of the arrangement"[1] (emphasis added). Those regulations provide, however, that transactions which are (i) entered into in the "ordinary course of business" consistent with "customary commercial practice" *and* (ii) with respect to which there is a "generally accepted understanding that the tax benefits are properly allowable for substantially similar transactions" are not "significant purpose" transactions.

A for what it's worth summary of the foregoing is that there are three levels. The first is the 'ordinary course/generally accepted understanding level,' which means no principal purpose, no significant purpose and no covered opinion burdens. The second is the 'important but not most important' motive,

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Circular 230...

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which places the practitioner in the wobbly 'significant purpose' zone. The third is the '*primus inter pares*/exceeds all other in importance' level, which triggers the mandatory covered opinion rules.

Where would a judicial finding of 'form over substance' or 'step transaction' leave the tax practitioner in the context of Circular 230? Would such a finding kick the deal into principal purpose status? Orphaned tax shelter regulations under Section 6662 (Treas. Reg. §1.6662-4(g)(2)(i)) refer to "mischaracterization of the substance of the transaction" as an indicator of a principal purpose to avoid taxes. The regulations, however, also provide that principal purpose transactions are those which reflect "little or no motive for the realization of economic gain," so even a structure which runs afoul of the step transaction doctrine should be able to qualify as significant purpose transaction as long as there is some motive for economic gain. If not, the tax advisor on the deal who failed to issue a covered opinion would be exposed to sanctions under Circular 230.

One might hope that this plays out so that a business purpose *always* saves a deal from slipping from significant purpose to principal purpose. Can, for example, a taxpayer say "I sold my business using this structure rather than that one, because the taxes were lower; consequently, no matter how aggressive the structuring, the principal purpose was to sell the business"?

The answer is that anything short of a truly nonstandard structure for selling a business will likely (dare I say more likely than not) qualify as, at worst, a significant purpose rather than a principal purpose transaction. Recall that the Section 6662 regulations define principal purpose transactions as transactions structured with little or no motive for the realization of economic gain. This includes transactions that utilize the mismatching of income and deductions, overvalued assets or assets with values subject to substantial uncertainty, financing techniques that do not conform to standard commercial business practices, and the mischaracterization of the substance of the transaction. Although that regulation needs to be amended to conform to recent changes in Section 6662, the provisions described above remain an excellent interpretive source. As such, they reinforce the conclusion that the structure in question is not a principal purpose transaction.

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Economic Development...

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pany; 2) the underlying principle of the Commerce Clause is to encourage competition among the states, including tax competition; 3) businesses should be free to choose to locate to the state whose tax system is most advantageous to it; 4) the court should not be used to accomplish that which the plaintiffs have been unable to accomplish through the legislative/political process; 5) a loss of economic investment and activity to foreign countries; 6) foreign investment in the United States would decline; 7) a significant impact on the financial statements of those companies showing their entitlement to incentives in the calculation of their profitability and the corresponding confusion in the financial markets.

Both sides in this matter requested review by the Supreme Court, agreeing that the case could have far reaching implications throughout the country. Clear direction from the Court as to what will constitute discriminatory state tax incentives is necessary.

In addition to the review of the matter by the U.S. Supreme Court, bills have been introduced in Congress to address the matter. In the Economic Development Act of 2005 (H.R. 2417, S.B. 1066), introduced in May 2005, Congress is attempting to authorize the States to provide certain tax incentives for economic development purposes. The summary of the bill provided by the Congressional Research Services describes the bill as follows:

Economic Development Act of 2005 - Authorizes any State to provide to any person for economic development purposes tax incentives that otherwise would be the cause of discrimination against interstate commerce under the Commerce Clause of the Constitution. Makes exceptions for any incentive that: (1) is dependent upon State or country of incorporation, commercial domicile, or residence of an individual; (2) requires the recipient to acquire, lease, license, use, or provide services to property created in the State; (3) is reduced or eliminated as a result of an increase in out-of-State activity by the recipient or other person or as a result of such other person not having a taxable presence in the State; (4) results in loss of a compensating tax system, because the tax on interstate commerce exceeds the tax on intrastate commerce; (5) requires that other taxing jurisdictions offer reciprocal tax benefits; or (6) requires that a tax incentive earned with respect to one tax can only be used to reduce a tax burden for, or provide a tax benefit against any other tax that is not imposed on, apportioned interstate activities.

These bills are currently in committee.

Though Maryland offers only limited forms of tax incentives to encourage economic development, the ultimate outcome of this case and the pending legislation could have substantial impact. An affirmation of the lower court's decision and the death of the pending legislation would go a long way to leveling the playing field. Taking away the tax incentive tool other jurisdictions use, Maryland will be in a better position to showcase the attractive assets it does possess, educated work force, quality infrastructure, high quality of life, to attract economic development.

Circular 230...

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Furthermore, the detour into Section 6662 leads to a practical insight that has been overlooked amidst the anguish over the principal purpose/significant purpose linedrawing problem. The reason new Circular 230 is so tough is that the Department of the Treasury is seething mad at the *inappropriate* sale of penalty protection by tax practitioners. This means that even if a transaction is aggressive, if it satisfies the penalty threshold – substantial authority, for example, or reasonable basis plus disclosure — the Treasury Department will tend not to have an interest in sanctions against the advisor *even if the advisor made the wrong choice* between principal purpose and significant purpose. In other words, if the IRS doesn't assert penalties against the taxpayer, how likely is it that it will second guess your Circular 230 analysis? Indeed, consistent with that read, a Treasury Department official participating in a panel discussion on Circular 230 has stated that the government will concern itself only with willful or gross misconduct.

Think of Circular 230 as a trapping mechanism: the more worried you are that your client might face penalties, the more worried the IRS wants you to be that you might face penalties. The less you think your client has to worry about, the less you have to worry about yourself.

Reliance Opinions

Of the four suspect categories of written advice concerning a significant purpose transaction, the reliance opinion element is of broadest interest. A reliance opinion is one that both the advisor and client expect will insulate the taxpayer from penalties. It is defined as an opinion which concludes that a Federal tax issue will "more likely than not" be resolved in the taxpayer's favor. The advisor can elect out of reliance opinion status by simply engaging in the awkward, client alienating, confidence reducing act of "prominently" disclosing, in a separate section of the written advice, in typeface equal to the predominant typeface in the written advice, that the opinion was "not intended or written by the practitioner to be used, and that it cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer."

Marketed Opinions

Marketed opinions are of some interest as well. Marketed opinions are opinions which the practitioner knows or has reason to know will be used or referred to by a person other than the practitioner in promoting, marketing or recommending a partnership or other entity, investment plan or arrangement to one or more taxpayers. The use of disturbingly general words like "recommended" and "used or referred to," casts a wider net than salesman-driven tax scams. I can "recommend" my tax strategy to an affiliate of my client, and I can "refer to" the structure proposed by opposing tax counsel. Is either instance really supposed to fall into this heightened category of scrutiny? A partial answer to the question is that an opinion that would otherwise qualify as a marketed opinion will not be treated as one if (i) the opinion expressly disclaims an intent to serve as a marketed opinion; and (ii) the subject matter of the opinion does not involve either a listed or principal purpose transaction. Restated, if the opinion relates to matters other than principal purpose or listed transactions, you can opt out. This does not, as a practical matter, help when the opinion becomes a marketed opinion by inadvertence, that is, because it is informally "recommended" or "referred to," as discussed above. Marketed opinions must conclude to a more likely than not confidence level with respect to each significant Federal tax issue, so marketed opinion status is highly undesirable.

Steering Clear of Covered Opinions

Let's summarize. Issuing a covered opinion puts you in a high scrutiny zone. All things being equal, therefore, you don't want to be issuing covered opinions. You could be in that zone, however, by, among other means, either issuing written advice on an entity, plan or transaction the "principal purpose" of which is tax avoidance or evasion (in which case it's the end of the inquiry: no opting out), or issuing written advice where tax avoidance or evasion is a "significant" but not the sole purpose. In that latter case, opting out may save you. (Remember, for the umpteenth time, that you can't opt out of giving a covered opinion if you opine on a principal purpose transaction, and remember that even a covered opinion on a principal purpose transaction doesn't give penalty protection unless it concludes at a more likely than not or better confidence level.)

In addition to escaping the obligation to issue a covered opinion by concluding that the transaction is merely a significant purpose transaction, other paths lead out of the covered opinion zone. These include (i) advice concerning the qualification of a qualified plan, (ii) advice from an in-house advisor, (iii) preliminary advice if the advisor reasonably expects to be asked to provide follow-up advice, (iv) advice on a State or local bond issue, (v) restricting written communications to deal documents and/or deal memos containing no explicit tax advice, (vi) advice not to enter into the proposed transaction and (vii) advice contained in documents required to be filed with the SEC.

Here's the most important path clear of covered opinions. A taxpayer *does* get penalty protection from an opinion which concludes that there is substantial authority for the position even if the confidence level is less than fifty percent, *provided the deal is a significant purpose transaction*. It's the most important path because will, if competently rendered, protect the client from penalties.

Significant Federal Tax Issue

Consider the following sentence: "Algernon has come up with a tax planning strategy (i) which *has tax avoidance as one of its significant purposes*, (ii) *a significant purpose [of which] is the avoidance of Federal income tax*

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Circular 230...

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and (iii) which *involves a significant Federal tax issue.*" Oscar Wilde would gag on a sentence as inelegant and imprecise as that. We are tax experts, however, so we see precision where the likes of Oscar Wilde, unlettered in the language of tax law, could not. While the sentence contains three confusingly similar ideas, each has its own definition under either Circular 230 or the tax shelter rules.

The first defined phrase, *has tax avoidance as one of its significant purposes,* is familiar from the earlier discussion of how the covered opinion rules apply differently to principal purpose and to significant purpose transactions. The second defined phrase, regarding a transaction *a significant purpose [of which] is the avoidance of Federal income tax*, is found in newly enacted anti-tax shelter provision, Section 6662A. If a transaction has *a significant tax avoidance purpose* under Section 6662A, the tax practitioner must determine whether certain extraordinary compliance and reporting rules apply. Insofar as the second defined phrase is employed as a defined term, the phrase should concern you only if you have clients who are very large and who have an appetite for aggressive tax planning.

The third phrase, *significant Federal tax issue,* describes the *threshold* under which tax advice can be given without having to worry about covered opinions. A significant Federal tax issue is a question concerning the Federal tax treatment of income, gain, etc. (or question concerning the value of property) with respect to which the IRS has a "reasonable basis for a successful challenge." In addition, to qualify as a significant Federal tax issue, the resolution of the issue must have a significant impact, beneficial or adverse, on the overall Federal tax treatment of the transaction or matter in question.

The word "significant," therefore, in this context means both something that's important in terms of magnitude — that is, a lot of money versus a little bit of money — but also in terms of the IRS' likely interest in the question. If the IRS has a "reasonable basis" for successfully challenging a position, then the IRS is likely to have an interest and therefore the issue is, in that sense, significant as well.

And why, pray tell, do you care? You care because when traveling in the dread land of Circular 230, the covered opinion rules *do not apply* if the tax advice does not concern a *significant Federal tax issue*. More precisely, if the IRS does not have a reasonable basis for a successful challenge, then the tax practitioner need not concern him or herself with the puzzle palace of covered opinions, substantial purpose and more likely than not formulations.

Covered Opinion Rules

The issuer of a covered opinion is on *inquiry notice* as to facts. That's the first rule.

Rule number two is that it must consider *all relevant facts.* (What's notable about rules one and two is that they apply to all written tax advice, whether pertaining to a principal purpose transaction, a significant purpose transaction or a transaction that slips under the substantial Federal tax issue threshold.)

Rule number three is that a covered opinion must consider *all significant Federal tax issues*.

Rule number four is that it must reach an opinion as to each such issue *as well as* to the overall transaction.

The last rule is that a covered opinion must either (i) reach a more likely than not conclusion, or (ii) contain a 'no penalty protection' disclaimer.

Clients won't like rule number four, the requirement to consider all significant Federal tax issues, because it will cost them a lot of money. Lawyers won't like the last rule, because it forces them either to put themselves in the line of fire by reaching a more likely than not conclusion or, by disclaiming, give the appearance of putting their own interests before those of the client.

Limited Scope Opinions

Advisors may provide a limited scope opinion, which is an opinion that considers less than all of the significant Federal tax issues, provided the advisor and the taxpayer agree that the opinion cannot be relied on for purposes of avoiding penalties other than with respect to issues addressed in the opinion. No limited scope opinions are allowed for listed transactions or principal purpose transactions. Marketed opinions can't be limited scope opinions.

Written Advice Other than a Covered Opinion

Even if a written opinion is not a covered opinion, the practitioner must satisfy some of the same requirements applicable to covered opinions. The opinion may not be based on unreasonable factual or legal assumptions. The practitioner may not unreasonably rely on representations or findings of the taxpayer or any other person. Further, the practitioner must consider all relevant facts which are either known or which should be known. Finally, the practitioner may not, in the written advice, take into account the possibility of an audit, that an issue will be raised on audit or that an issue will be resolved through settlement if raised.

Respondeat Superior/Malpractice

Tax advisors who are responsible for overseeing a firm's tax practice "should take reasonable steps to insure that the firm's procedures for all members, associates and employees are consistent with the best practices." This means that the firm as a whole has a direct rather than a merely indirect stake in being able to claim that it took the Circular 230 best practices exhortations to heart. Here's some advice which, more likely than not, you would feel stupid not following: make sure your firm has a written policy on Circular 230 compliance.

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Circular 230...

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Compliance with Circular 230 bears on malpractice exposure as well. "Morality is that attitude we adopt towards people we dislike," said our Victorian quipmeister. In a similar spirit, a malpractice claim is the attitude unhappy clients adopt towards tax advisors whose advice exposes them to accuracy-related penalties without fair warning. In other words, if your client is at risk for an accuracy-related penalty, make sure you say so, so the client rather than you or your malpractice carrier coughs up the cash to pay it.

The Importance of Being Zealous (continued)

Let's return to Algernon's meeting with Gwendolin and Cecily and consider whether Algernon has created problems for himself, and perhaps for his clients, under new Circular 230.

The first of the three issues discussed was whether the subdivided real estate was held for investment under Section 1031. The threshold Circular 230 question is does it involve a significant Federal tax issue? Recall that a Federal tax issue is significant if the IRS has a reasonable basis for challenging the taxpayer's position, that is, a more than merely arguable shot. The 'held for' issue appears to meet that threshold. This is consistent with informal statements from Treasury officials that if the application of the law to the facts is problematic, the issue is a significant Federal tax issue.

We might also ask if the arrangement is "consistent with the statute and Congressional purpose." If it is consistent, it's not a principal purpose transaction. That's a difficult call, since the analysis turns on bad facts rather than aggressive structuring. Perhaps we can back into concluding this is not a principal purpose transaction by virtue of Algernon's belief that he has substantial authority for the position. Note that an arrangement can be consistent with the statute and Congressional purpose and yet still be a significant purpose transaction. The 'consistent with the statute and Congressional purpose' exception allows an escape from principal purpose status but not from significant purpose status.

If we are right so far, we have a possible covered opinion problem, because it's a substantial Federal tax issue. We can deal with it, however, as a lower cost, lower risk substantial purpose matter. Does that mean a substantial purpose "reliance opinion?" If so, avoiding principal purpose status is not much of a consolation, as either way the clients bear the cost of a covered opinion. But Algernon *can* help his clients short of a covered opinion, reliance or otherwise. He can opine that there is substantial authority for this position and nothing more, and with that, Cecily and Gwendolin are likely to be protected from accuracy related penalties on that issue. Since it is not a more likely than not opinion, moreover, Algernon doesn't have to worry about whether or not he should include penalty disclaimer language.

There is a temptation to take a better-safe-than-sorry approach and include the disclaimer language anyway. Algernon will weigh this temptation against the cost of conveying subliminally the message that he and his clients are not on the same side.

Regarding the second issue, Cecily's plan to separately reinvest her share of the sales proceeds, we begin with the same inquiry, does it involve a significant Federal tax issue? Algernon's idea, a presale redemption of Cecily's interest in the owning entity, is almost certainly a structure that the IRS would have a reasonable basis for challenging, if only based on the step transaction doctrine. Consequently, it is surely a significant Federal tax issue, and we have to consider whether or not to issue a covered opinion.

Are we at least under the threshold for principal purpose transactions? Recall that a transaction which is consistent with the statute and Congressional purpose is not a principal purpose transaction. Is a partner redemption in anticipation of a 1031 exchange consistent with Section 1031 and Congressional purpose? Likely not. Are we then stuck with the principal purpose transaction, and all the attendant extra work and risk to the tax practitioner attendant upon that status?

Probably not. Consider that tax shelter regulations under Section 6111 provide that transactions which are consistent with "customary commercial practice" and with respect to which there is a "generally accepted understanding that the tax benefits are property allowable for substantially similar transactions" are not *significant purpose* transactions *under the tax shelter rules*. While Circular 230 does not explicitly incorporate definitions found in the tax shelter regulations, transactions which satisfy the "consistent with customary commercial practice" found in the tax shelter regulations are, it is fair to surmise, not high scrutiny transactions under Circular 230. Since the structure involving a redemption just prior to the sale of relinquished property has been widely discussed in tax publications, one could reasonably conclude that this transaction satisfies that standard and is therefore neither a *significant purpose* transaction under the tax shelter rules nor a *principal purpose* transaction under Circular 230.

On the other hand, Algernon may feel that using language in the tax shelter regulations to bootstrap the deal out of even the significant purpose requirements violates the too good to be true rule. He may also reason that, while there is a generally accepted understanding that the tax benefit of deferral is properly allowable under his proposed structure, there is no single, best customary commercial practice for achieving deferral, so he hasn't even formulated a threshold case for relying on the language in

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the tax shelter regulations. Finally, he may wisely conclude that the definitions under the tax shelter regulations which predate new Circular 230 are not necessarily controlling under Circular 230.

Algernon will likely decide therefore either to treat it as a principal purpose transaction or to split the difference between principal purpose and the less-than-substantial-purpose status suggested by the tax shelter regulations and treat it as a substantial purpose transaction. If he treats as a principal purpose transaction, he can give Cecily and Gwendolin penalty protection, because, as the facts recite, he believes they will more likely than not prevail in the event of an IRS challenge. (You can give a covered opinion for a principal purpose transaction without coming to a more likely that not conclusion; however the opinion won't protect your clients from imposition of penalties.)

His promise to confirm that conclusion with his clients in a "quick e-mail," however, is a mistake. If he wants to opine about a principal purpose transaction, and intends, moreover, for that opinion to provide penalty protection, he needs to comply with the burdensome covered opinion requirements rather than conveying his conclusion in a quick e-mail. (Note here that *his* problem with a short e-mail response is noncompliance with Circular 230, while his clients' problem is losing penalty protection.) The quickest, least expensive solution may be to skip the opinion altogether and just prepare an outline of the structure (with no discussion of the tax motive behind any of the steps) and do the documents. Neither the outline nor the documents constitute written advice for purposes of Circular 230.

As to Gwendolen sharing whatever writing Algernon produces with her colleague, that might void the attorney client privilege and it could possibly turn the writing into a marketed opinion. A marketed opinion is a high scrutiny category of written advice, and Algernon wants earnestly to avoid it. Algernon, therefore, has both malpractice and Circular 230 reasons for not consenting to Gwendolen forwarding the advice.

Regarding the third issue, the horse farm, an IRS agent capable of reading minds would know that Algernon did not believe that Cecily's new spread was being purchased for the purpose of operating a business at a profit. Since Circular 230 requires Algernon to evaluate the reasonableness of client representations, he would appear to be in violation of Circular 230. Further, his unreasonable reliance is a violation whether or not his advice is in the form of a covered opinion, a non-reliance substantial purpose opinion, other written advice, or, indeed, even if it was conveyed verbally.

For purposes of this exercise, however, let's not impart mind reading powers to the IRS. Let's assume that Algernon reasonably relied on the facts presented by his client. Does this involve a significant Federal tax issue; that is, would the IRS have a reasonable basis for challenging the operated for profit status? As presented, the facts suggest some vulnerability to an audit adjustment, so let's assume the answer is yes. Does it, on the other hand, qualify for the highly undesirable status of principal purpose transaction? If Cecily attempts to operate the horse farm at a profit, then the arrangement is consistent with the statute and Congressional purpose, and it is therefore not a principal purpose transaction. Restated, if operating a business is the principal reason for buying the farm, which it is, then operating the farm in a way that avoids application of the hobby loss rules can't also be the principal purpose. It is, therefore, at worst, a significant purpose transaction.

How about the tax shelter language about customary commercial practice and a generally accepted understanding that the tax benefits would be allowable for substantially similar transactions? Can Cecily use that language to escape even significant purpose status? No. Given the volume of caselaw on this issue, the fact specific nature of the tax issue and Cecily's announced desire to slow down, Algernon should fashion his tax advice relating to the horse breeding arrangement on the assumption that it is a significant purpose transaction.

What about Algernon's consideration of the likelihood of an audit? If you think he's okay as long as he doesn't discuss the likelihood of an audit in a written opinion, you would be wrong. Circular 230 provides, even in the requirements for "other written advice," that the practitioner may not, in *evaluating* a federal tax issue, take into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved through settlement.

Does this mean that you can't mention these things to your client? Surely not! It means that you can't use those considerations in deciding whether you've reached a relevant opinion threshold, such as more likely than not or reasonable basis. Remember, however, that a verbal opinion is neither covered by Circular 230 nor of any use to the client in avoiding the imposition of a penalty.

Algernon has some other problems as well. Insofar as he concludes that one, but less than all of the transactions, plans and arrangements that he discussed in connection with the sale and reinvestment require a covered opinion, it is possible that all the transactions discussed are part of that transaction, plan or arrangement. In that case, the burdensome covered opinion rules would apply to all aspects of every part. A determined Office of Professional Responsibility could certainly make a good case for grouping the core like-kind exchange transaction with the structuring intended to allow Cecily and Gwendolyn to reinvest in different properties.

If that possibility concerned Algernon, he might elect to issue a limited scope opinion, which is allowed for significant purpose (but not principal purpose) transactions. He should also

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worry, however, about whether a *non-reliance* opinion on a significant purpose transaction can be issued side by side with a limited scope opinion. In other words, do you violate the limited scope opinion rules by delivering a limited scope opinion on one significant purpose transaction and non-covered opinion tax advice on a related transaction? (Probably not. Since each should be a significant purpose transaction, however, Algernon should just issue non-reliance opinions on both of them, thereby sidestepping the covered opinion rules entirely.)

Algernon has created another problem for himself by handing his clients a copy of his meeting notes. His meeting notes may constitute written advice, and all written advice has to be tested against the covered opinion rules of Circular 230. His defense would be that the covered opinion rules do not cover preliminary advice if the advisor "reasonably expects" to be asked to provide follow-up advice. The problem is that Algernon wasn't planning to give Cecily any written tax advice on the hobby loss issue.

The fact that he did not plan to give written advice about the horse farm is also a problem, because the same factors relevant to the hobby loss issue might have led Algernon to recommend that Cecily try to qualify the farm as like kind property under the original transaction. Algernon probably doesn't deserve it, but he may have malpractice exposure if he misses this issue, an ethics problem if he doesn't identify where the interests of his joint clients diverge and a compliance issue under Circular 230 if he issues a covered opinion on the like kind exchange without identifying it as a significant Federal tax issue. (I think the second and third items, especially the third, are stretches.)

Although Congress probably didn't intend it, Algernon may also want to give some thought to the tax shelter rules. There is a large body of tax shelter regulations currently in effect which predate both new Circular 230 and stricter tax shelter rules ushered in with the 2004 American Jobs Protection Act. Overlapping and inconsistent terminology, manifest in the many uses of the word 'substantial' discussed above, leave this area of the law in an incoherent knot.

Last but, in dollar terms and regulatory burden, certainly not least, consider that the proposed like-kind exchange involves a book-tax difference of more than $10 million. If the clients satisfy certain other requirements (for example, either $250 million in gross book value assets or publicly traded stock), the like-kind exchange proposed by Cecily and Gwendolen may constitute a reportable transaction. Reportable transaction status under Treas. Reg §1.6011-4 triggers unpleasant additional reporting and record keeping obligations for both taxpayers and their tax advisors.

Conclusion

It's a new day for tax practitioners. The interests of practitioners, never fully aligned with their clients, has been thrown further out of alignment by Circular 230. Taken together with recently enacted tax shelter reporting obligations, the language of new Circular 230 reflects a trend towards turning tax planners into gate keepers for the IRS, albeit uncomfortable ones.

As it happens, Oscar Wilde anticipated this trend: "It is perfectly monstrous," complains Lord Illington in 'A Woman of No Importance,' "the way people go about nowadays, saying things about one behind one's back that are absolutely, entirely true."

Selected Review of the 2006 Heckerling Institute on Estate Planning

by Harold W. Pskowski, Esq.

The Heckerling Institute on Estate Planning, held in Miami Beach on January 9 - 13, 2006, accurately bills itself as the country's largest gathering of estate planners. This year, the conference offered its usual broad array of speakers and workshops on estate planning topics. In light of the decreased importance of transfer tax planning for many estates, the 2006 conference continued a trend of de-emphasizing highly technical discussions of transfer tax issues. Instead, there were additional sessions on trust planning, fiduciary litigation, financial planning, and other non-tax issues. The Fundamentals Program, added several years ago, remains popular. These three-hour sessions offer an overview of a specific estate planning area, and this year included speakers on plan beneficiary designations, asset protection, and elder law.

This report, rather than focusing on the individual speakers and sessions, looks at some of the common themes and trends that emerged during the course of the conference. For a more detailed look at the individual sessions, members of the ABA Real Property, Probate and Trust Section have posted reports on the Section's web site at http*://www.abanet.org/rppt/meetings_cle/heckerling/2006/home.html*. Any reader interested in a specific session should refer to this site.

Future of the Estate Tax

The politics of the federal estate tax was addressed in two separate sessions: the Current Developments session with Dennis Belcher, Carol Harrington, and Jeffrey Pennell, and a separate session on "Keeping Up With the Estate Tax" by Ron Aucutt of McGuireWoods LLP.

The consensus opinion among the speakers was that the estate tax is not going to be repealed. Carol Harrington

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offered a detailed chronology of the closed-door discussions in Congress last summer that almost resulted in a political compromise on the estate tax, until the fiscal demands of Hurricane Katrina made that impossible. Ron Aucutt believes that a compromise may be reached this summer, even though many believe that nothing can happen in an election year. According to Aucutt and other speakers, there appears to be a growing consensus for an estate tax with higher exemption coupled with a flat rate tied to the capital gains tax rate.

State Death Taxes

There was considerable discussion of the impact of state death taxes, both in the Current Developments session and the estate tax session led by Ron Aucutt.

Aucutt stated that in many cases the best planning method for avoiding state death taxes in a state with a de-coupled credit is the use of death-bed gifts. Because the states (including Maryland) do not have a gift tax, the gifted property completely escapes state tax. This method has no impact on the total federal tax liability, except to the extent that the state death tax deduction is reduced or eliminated. Although a federal gift tax return will have to be filed and (depending on the size of the gift) gift tax paid, the gift tax will offset the federal estate tax on a dollar-for-dollar basis.

Aucutt warned that this technique should be used only when the client is truly on his or her deathbed. If the client should recover her health after the gift is made, she may not be pleased at having been advised to give away most of her wealth. Because the client may not have the physical capacity (or the time) to make the transfer shortly before his death, Aucutt recommended that the gift be made using a durable power of attorney. He indicated that an even better technique is to have the client's property held in a revocable trust, in which a trustee or trust protector has the power to terminate the grantor's interest in the trust, resulting in a gift to the remainder beneficiaries. This will facilitate the completion of the gift in a timely manner, as (1) it will require no action on the part of the grantor and (2) it will not be necessary to transfer title to the assets to complete the gift. He warned, however, that it would be best to avoid using this technique with low-basis assets, as they will lose the basis step-up at death.

Aucutt also pointed out that the federal GST tax rate (46% in 2006) is currently less than the combined federal and state estate tax rates (a combined 54.64% rate for Maryland decedents dying in 2006, taking into consideration the federal deduction for the Maryland tax). There may be situations, such as in the termination of generation-skipping trusts, where there is a choice between paying estate tax or GST tax. In such cases, he said, it may be wiser to choose the GST tax. This might also be considered in drafting generation-skipping trusts, although this requires caution because it is almost impossible to predict the future tax rates.

Dennis Belcher also addressed state death taxes during the Current Developments session. He pointed out that, in addition to the estate tax imposed by the state of domicile, it is necessary to plan for each state in which the client owns real estate. If the situs state has a more favorable death tax than the domicile state, he recommended that the real estate not be placed in an LLC, which will transform it into an intangible that is subject to tax in the state of domicile. He also noted that the § 691(c) IRD deduction for federal estate tax paid on an IRD item does not extend to the state death taxes imposed on the IRD property. Thus, if an IRD item will be subject to state estate tax, it may be possible to reduce the overall tax by accelerating the recognition of the income during life, because the income tax paid on the accelerated income will reduce the size of the estate.

Family Limited Partnerships

Family limited partnerships were addressed by a number of speakers, although there was less of an emphasis on this topic than in prior years. The Current Developments panel discussed the cases decided during 2005, highlighting *Bongard Estate* and the most recent 5th Circuit decision in *Strangi Estate.* The panelists agreed that the Service had been successful with its § 2036(a) argument, but that a properly drafted and operated FLP could still escape § 2036(a), especially if the FLP held only investment real estate and business assets.

An afternoon workshop on "Transfer Tax Audit Issues: What's Hot," spent considerable time on FLP audits. The panel, which included both practitioners and IRS field agents, agreed that audits of FLPs are focusing on § 2036(a), due to the IRS's recent success on that issue in the courts. Martin Basson, the director of the IRS estate and gift tax office for southern Florida, said that his office currently has 73 FLPs under examination and that examiners are making regular use of summons to both family members and health care providers to determine the status of the decedent's health and his motivation in setting up the FLP.

James Gulley, the director of the IRS estate and gift tax office in Houston, Texas, said that his office currently has 86 FLP examinations in progress. He mentioned that, in addition to § 2036(a), his office is raising the § 2703 and gift-on-formation arguments.

In addition to these cases under current examination, Basson stated that there are now 206 FLP cases before the National Appeals Office and that 70 cases are docketed in the Tax Court and other courts. He initially declined to discussed the settlement guidelines that are supposedly used in Appeals, but later stated that settlements usually allow a 25 - 35% discount on the underlying assets, as long as the IRS is satisfied that it cannot make a case under § 2036(a). If the IRS feels that it can be successful on the § 2036(a) issue, it will not offer any discount.

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Trusts

Trusts were a common topic, addressed by several speakers. Sam Donaldson of the University of Washington School of Law gave an entertaining talk on the use of grantor trusts. He acknowledged the trend to use "defective" grantor trusts, for which the grantor retains the income tax liability while keeping the trust assets outside his estate. He noted, however, that there are cases in which it is preferable that the trust pay its own taxes. If the grantor is already in a high income tax bracket, subject to phaseouts of itemized deductions and personal exemptions, he pointed out that it may be better to use non-grantor trust status, especially if most of the trust income is dividends and long-term capital gains, taxable at a 15% rate. He also observed that, if the grantor lives in a high-tax state, it may be better to use a non-grantor trust with a situs in a state with no or low income tax. In this connection, Richard Nenno of Wilmington Trust followed with an excellent session on how to change the situs of a trust for tax or other purposes.

The same morning, Kimbrough Street of Davis Wright Tremaine in Seattle discussed the issues involved in selection of a trustee, focusing on the non-tax aspects. She emphasized that grantors frequently give little thought to the choice of a trustee, and discussed the importance of locating a trustee who shares the grantor's values and has the necessary technical skills. Her material included an excellent trustee selection checklist that can be given to clients to assist in their selection of an individual or institutional trustee.

Medicaid Eligibility for Nursing Home Care

Larry Frolik of the University of Pittsburgh Law School presented an enlightening Fundamentals session on Elder Law, including a discussion of proposed changes in Medicaid eligibility for nursing home costs. He pointed out that Congress was then considering legislation that would make it more difficult to qualify for Medicaid reimbursement following an asset transfer. The proposal would: (1) increase the look-back period for non-trust transfers from three years to five years, (2) discourage the conversion of assets into annuities, and (3) commence the period of ineligibility with the date of application for Medicaid, rather than the date of the asset transfer. The change in the commencement of the period of ineligibility would eliminate "half a loaf" planning, in which a Medicaid applicant would give away 50% of his assets while retaining the other 50% to cover the cost of nursing home care during the period of ineligibility.

At the time of his talk, this proposal has already been approved by both houses of Congress as part of the Deficit Reduction Act of 2006, but had to return to the House of Representatives for a final vote on several Senate amendments on other provisions. The House approved the final bill on a 216-214 vote on February 1, 2006, and as of this writing, the bill is on it way to the President for signing. The effective date of the legislation will be the date it is signed by the President. Any asset transfers made before that date are grandfathered under the current rules.