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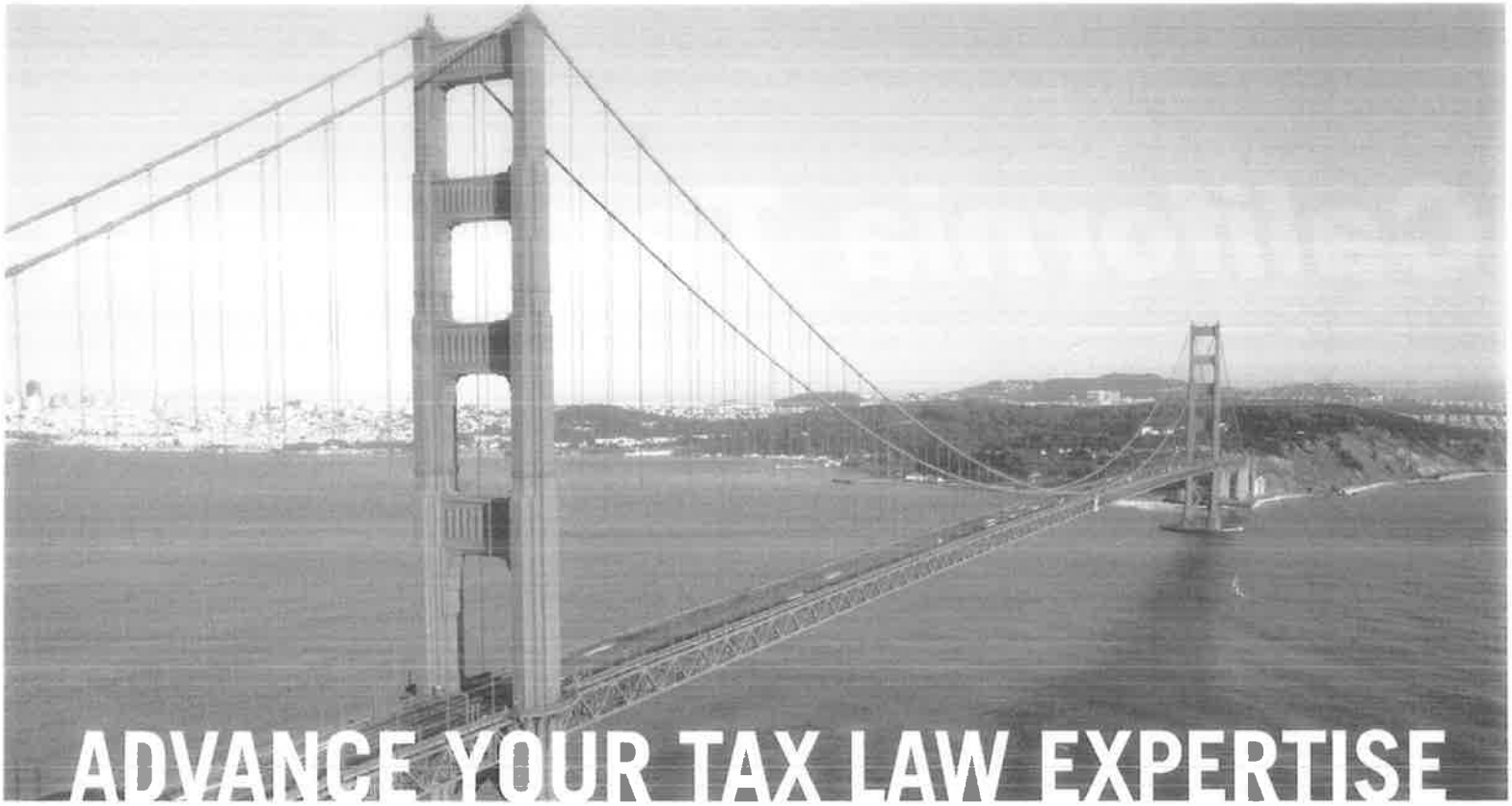
Highlights



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Message From The Chair

By Fred Campbell-Craven[1]

Well, here we go. Funny how you can spend four years on the Executive Committee and then all of a sudden you're supposed to know what you're doing. When I think of those friends and great role models who have preceded me in this job during my time on the Executive Committee—Brian Toman, Wayne Johnson, Michelle Ferreira, Carley Roberts, and Doug Youmans—I can only hope to be able to serve the members of the Section half as well as they did. My immediate predecessor, Doug Youmans, is a particularly difficult act to follow; on behalf of the Executive Committee, if not the entire Taxation Section, I'd like to offer him a warm thanks for his continuing service and the excellent leadership he has provided over the past year as Chair. It has truly been appreciated. I will continue to rely heavily on his generous counsel and wisdom during the coming year, so I'll take this opportunity to thank him in advance for that too.

Our Immediate Past Chair, Carley Roberts, is another example of how high the bar has been set when it comes to devoting countless hours of service to the Section. Carley virtually single-handedly revived and reenergized the California Tax Policy Conference after it had been in unfortunate hiatus for a number of years; an effort for which she cannot possibly receive enough thanks from us all. She and Annette Nellen, a Vice Chair of the Executive Committee, have labored mightily to bring us the 2012 Annual Meeting of the California Tax Bar & California Tax Policy Conference, which is to be held November 1-3, 2012, at the Loews Coronado Bay Resort in beautiful San Diego. This is California's premier tax event, and is designed to provide not only cutting-edge instruction and discussion of topics of interest to us all, but also to facilitate and strengthen the professional relationships between private practitioners from some of the most respected legal and accounting firms in the country and the numerous federal and state tax officials and administrators with whom they interact. This year's Conference will provide 40 educational sessions, including full multiple-day program tracks covering Estate and Gift Tax, Tax Procedure and Litigation, and State and Local Tax. We'll also have programs on the latest developments in the taxation of corporate and other business entities, income tax, international tax, tax legislation and tax policy, as well as programs co-developed by the Young Tax Lawyers Committee. Apart from the educational content, the Conference presents a unique opportunity for registrants to engage in many networking events. Among the events scheduled are major luncheons with keynote speakers on Thursday and Saturday; committee luncheons on Friday; an annual dinner with entertainment on Friday night; and cocktail receptions on Thursday and Friday evenings, including a special Young Tax Lawyers gathering on Thursday night. Hope to see you there!

This time of year is also notable because we need to bid a fond adieu to a number of friends who are finishing their three-year terms on the Executive Committee. Rolling off this year are Kornelia Davidson, David Roth, Julie Treppa, and Erin Wilms. All of them will be greatly missed; I can't thank them enough for their hard work, professionalism, and friendship freely offered during the past three years. Knowing them to be the great folks that they are, I'm sure they will continue to serve the Section in the same generous spirit that they have before. I know we will continue to rely on their advice and counsel. A small consolation is that the fifth member of their class, Brad Marsh, will stay on for another three years beginning this year as Chair Elect of the Section. Based on our past experience, I know I can look forward to working with him for the next two years and that he will do great things for the Section.

This time of year is also when we welcome a new freshman class to the Executive Committee. Joining this year are Valerie Dickerson, of Deloitte Tax LLP in Costa Mesa; Thomas Giordano-Lascari, of Wayne R. Johnson & Associates, of Los Angeles; Justin Miller, of BNY Mellon, in San Francisco; Haleh Naimi, of Advocate Solutions, Inc., in Beverly Hills; and Betty Williams, of the Law Office of Williams & Associates, LLP, in Sacramento. They have some rather large shoes to fill, so I hope you will offer all of them your advice and encouragement when you see them at the Conference.

I've already mentioned how much we all owe our rolling off Immediate Past Chair, Carley Roberts, for all of her work on behalf of the Section and in particular the California Tax Policy Conference. Her example of selfless service is truly daunting, one which I cannot hope to emulate in even some small modified way. I am rather humbled to announce, then, that Carley has agreed to stay on as an Advisor to

the Section despite having already completed her official six years of service, and that she will continue to share her wealth of experience and provide a guiding hand in running the California Tax Policy Conference with those of us trying to follow her example. I am truly grateful to her, and hope that you will echo my thanks when you see her at the Conference.

The Executive Committee continues its annual planning efforts year round. Looking forward, Eagle Lodge West will be held on April 26-27, 2013, at The Vintner's Inn in Santa Rosa. For those not familiar with Eagle Lodge West, select individuals in private practice and representatives from the Franchise Tax Board and the State Board of Equalization meet to identify legal issues of common interest and attempt to reach consensus solutions. In the past, these sessions have led to statutory changes, regulatory projects, legal rulings, and other mutually agreed solutions to improve tax administration in California. Hence, we intend to continue to avail ourselves of the opportunity to address and, hopefully, offer insight into resolution of issues in this unique forum. Attendance is by invitation only. For more information on Eagle Lodge West, contact Brad Marsh (telephone: (415) 591-1400; email: bmarsh@winston.com) or Valerie Dickerson (telephone: (714) 436-7657; email: vdickerson@deloitte.com).

Also coming soon, the Taxation Section will make its annual pilgrimage to Washington, D.C., on May 5-8, 2013. Undertaken in conjunction with the Los Angeles Country Bar Association Taxation Section, the purpose of our Washington Delegation is to present issues of importance to California taxpayers (and the tax community at large) to the judges of the U.S. Tax Court; representatives from the Internal Revenue Service and the Taxpayer Advocate's Office; senior officials in charge of tax policy at the U.S. Treasury Department; and senior tax staffs of the Joint Committee on Taxation, the House Ways and Means Committee, the Senate Finance Committee, and sometimes various members of our California Congressional delegation. In short, the delegates make certain our voice is heard by our leaders and colleagues in Washington. Washington Delegation paper topics are currently being solicited. Please consider joining the Delegation by writing a paper, or at least submitting for consideration a topic involving some timely cutting-edge legislative, regulatory, or administrative issue you have encountered. For more information about the Washington Delegation, including paper requirements and timelines, visit the Taxation Section's website or contact Geoff Weg (telephone: (310) 277-8011; or e-mail: gaw@vrmlaw.com), the 2013 Delegation's chair.

Finally, I look forward to maintaining the quality of our quarterly publication, the *California Tax Lawyer.* As a primary means of facilitating communication with our membership regarding events and programming, the *California Tax Lawyer* includes timely articles by accomplished writers, and I encourage each of you to consider the *California Tax Lawyer* for publication of your next article.

I look forward to working with you in the coming year. We have a great Section that contributes in a meaningful way to the betterment of the profession, but it can't hope to accomplish any good without the involvement of each of us. In that regard, I encourage you to get involved, whether it be by joining a standing committee to share your thoughts, ideas, and energy; by speaking at the Annual Meeting of the Tax Bar and California Tax Policy Conference; by participating in the Washington D.C. Delegation or Eagle Lodge West; by submitting an article or drafting your Committee's quick points for *California Tax Lawyer;* or by participating in any of the other numerous activities the Section sponsors or facilitates. And please don't hesitate to call or email if I can be of service.

See you in San Diego!

ENDNOTES

1. Mr. Campbell-Craven is a Tax Counsel IV with the California Franchise Tax Board. Any views expressed here are those of the author, and do not represent those of the Franchise Tax Board or the State of California. He may be reached directly at (916) 845-3796 or fred.campbell-craven@ftb.ca.gov.

Taxation of Regulated Internet Gambling

By: Sanford I. Millar, JD, MBT[1]

I. INTRODUCTION

This Article surveys global licensing and taxation models applied to Internet gambling. We provide in Part II a categorical overview of Internet gambling licensing and taxation models, and summarize each model's apparent advantages and disadvantages. In Part III we survey a broad sample of regulated online gambling licensing models, describing how particular models are implemented within each jurisdiction, and then comment on the strengths and shortcomings of each approach. Part IV then provides an overview of the current regulatory environment and emerging trends in the United States among jurisdictions considering legalization of Internet gambling. Part V concludes with recommendations, as well as a summary of the survey from Part III.

II. INTERNET GAMBLING LICENSING AND TAXATION MODELS

Internet gambling licensing and models can generally be described within the following categories: (1) monopoly models, such as lotteries operated by state, provincial or national governments; (2) free market models, which have licensing fees with nominal up-front or ongoing costs and where there is no pre-set limit on the number of licenses which can be issued; (3) limited free market models, where the total number of licenses granted is determined in advance by legislation or regulation; and (4) hybrid models involving combinations of the above, usually with splits among game types and/or local jurisdiction. Within these licensing models are taxation models. The taxation models are in the form of an ongoing licensing fee; that licensing fee can be based upon (a) Gross Gaming Revenue ("GGR"); or (b) Gross deposits or "Net" deposits, or turnover, each of which are discussed below.

A. Monopoly Models

Monopoly models exist where state, regional (or provincial) or national governments operate online interactive gambling sites directly or through a government sponsored entity ("GSE"). In those jurisdictions where a monopoly model is used, competitive sites including offshore gambling[2] sites are prohibited, though there are a few exceptions.[3] Monopoly models are used to regulate a wide variety of Internet gambling activities, from lotteries and fixed-odds games[4] to pari-mutuel betting,[5] bookmaking,[6] as well as peer-to-peer ("P2P") and other traditional casino games.[7]

The primary advantage of a monopoly model from a regulatory perspective is the amount of control it places in the hands of the relevant governing body. The governing body in these jurisdictions is either an operator itself directly or through a government agency or GSE, or licenses a single operator. Because the governing jurisdiction is the sole licensed operator, it faces little or no lawful competition. Competition from unlicensed sites and from sites operating under an extraterritorial license may still be a factor, however.

As in any jurisdiction outlawing online gambling in general, monopoly models may encourage unlicensed competition, both from domestic and extraterritorial sites. That is, customers may seek gaming services from unlicensed operators either from within the jurisdiction or—perhaps more likely—from offshore operators located in jurisdictions which do not prohibit such operators from providing services extraterritorially, or even only grant extraterritorial licenses.[8] Similarly, the revenue that might be enjoyed from multiple operators competing to attract customers could also be sacrificed. A monopoly model revenue could be further constrained if the monopoly has a limited product offering. Thus, under a monopoly regulatory model, a certain amount of operator revenue may be lost to competitive operators who have extraterritorial licenses. Furthermore, the regulatory control, which is absolute as applied to the licensed operator, does not offer consumer protection from competitive offshore operators.

B. Free Market Models

Jurisdictions intending to attract the maximum number of Internet gambling site operators (including those that offer extraterritorial licenses only) typically adopt free market regulatory models focused on the provision of licenses for fees. The specific structure of such licensing differs by jurisdiction, but most involve an application fee, initial license fee, subsequent renewal fees and on-going taxation, all of which might differ within the jurisdiction depending on the type and size of the operation. In free market jurisdictions, there is no limit to the number of

licenses granted, nor are there usually constraints on the types of games permitted.

As the practical antithesis to a monopoly model, the free market models benefit from the number of operators they license, and how attractive the jurisdiction is to operators. In the competitive global marketplace of Internet gambling, operators may move to jurisdictions with favorable regulatory and taxation environments. The attraction to the jurisdiction of licensing more Internet gambling businesses is the revenue generated both directly from licensing, and indirectly through ancillary businesses based in the jurisdiction (such as financial institutions, technology providers, and hosting services). The lower the license fees and the operating costs to the site operator, the more operators are attracted to the jurisdiction.

Finally, perhaps the greatest advantage from a regulatory perspective is that regulators can structure the licenses so that they receive flat fees up-front (for each period of licensure). For example, the licensing body might require an advance deposit, which would be credited against license fees in the ensuing years of operation. This is a "use it or lose it" approach so that the revenue risk to the licensing body is minimized.[9]

C. Limited Free Market Models

Limited free market models attempt to address some of the disadvantages of the unlimited free market models by capping the number of licenses granted, offering a few licenses with higher probity standards or more stringent license applications, imposing stricter regulatory control over licensees, or by implementing any combination of these restrictions and limiting the services to within the jurisdiction.

Operating in a limited free market jurisdiction can still be affected by competition from offshore operators who have extraterritorial licenses, however. Until the issuance of extraterritorial licenses is approached on a cooperative international basis, the recourse of each jurisdiction can be problematic.

D. Licensing Fee Models Based Upon Gross Gaming Revenue Tax

Under a Gross Gaming Revenue ("GGR") tax model, operators pay a percentage of their revenues, calculated on the basis of the amount wagered by all of their customers minus the winnings returned to the players. This is often subject to additional deductions for certain expenses such as software licensing and development costs, chargebacks on credit cards, and other overhead, but deductions can be capped at a certain percentage of GGR.[10] As illustrated in Parts III and IV, the GGR tax model is a method often used by some jurisdictions that license Internet gambling and may also be hosts for land-based casinos. GGR tax rates on Internet gambling generally range from 2-5 percent in the Caribbean to 15-30 percent in the European Union.[11] They are typically consistent across various types of gaming within a jurisdiction, but sometimes vary, with different games sometimes being subject to differing license fees.[12]

The most commonly cited advantage of a GGR model (as opposed to a turnover, deposit model or net deposit model) is that operators enjoy lower business risk as they are only taxed on their gaming profits, not on player bets or deposits. The GGR model is most often used where the jurisdiction is already taxing land-based casinos using the GGR model.

While a GGR tax lowers the business risk operators face in Internet gambling in comparison to a deposit model, however, the primary disadvantage of the GGR model is that taxes are collected in arrears—at the end of the year or customer life cycle—so regulators do not receive tax revenue in as timely or predictable a fashion. Furthermore, because customers establish revolving accounts with Internet gaming operators, the interim period between the operator's initial gaming revenue (amount wagered) and payout of winnings is potentially indefinite. This becomes an issue of special significance where operators are free to offer promotional credits, a common practice in the Internet gambling industry.

Therefore, the GGR amount has to be calculated periodically, rendering the taxes more complex and somewhat variable even between periods of similar gaming activity. The alternative—waiting for a customer to close out his or her account before calculating GGR—would mean that taxes are never collected when accounts are left open, even while operators enjoy the benefits of the intervening float (for example, the ability to invest the money deposited in player accounts). Finally, the higher complexity of a GGR model in the context of Internet gaming—especially across multiple jurisdictions—increases transactional costs in general, and adds the risks of arrears tax collection (for example, operator insolvency) to the governing body's risk burden.

E. Licensing Fee Models with Deposit or a Turnover Tax

The chief alternative to a licensing model with GGR taxation is to base a tax on the funds the player deposits with an operator. Licensed operators are required to pay a tax calculated by applying a stipulated percentage to the amounts deposited by players. The rate used under such a model is usually much lower than the GGR rate in a particular market—from less than 1 percent in free-market-

oriented jurisdictions such as Malta and Belize to 5-7.5 percent in other European nations.[13]

A deposit tax model is more efficient to apply to online gambling than a GGR for the reasons outlined herein—the primary distinction being that it is collected in advance as opposed to collection "in arrears" which reduces the revenue risk to the licensing jurisdictions. Furthermore, the deposit tax is game neutral, unlike the calculation of tax on GGR for an operator offering a variety of game types, thus simplifying the tax calculation, and remission processed, particularly in cases where the deposit tax is implemented across multiple jurisdictions. Finally, a deposit tax provides a mechanism for strengthening enforcement of gambling laws against unlicensed operators, whereby players might themselves incur liability for the deposit tax (plus penalties) if playing with unlicensed or otherwise "illegal" operators.

Some critics of the deposit tax model claim that such a regime deters the establishment of regulated gambling.[14] These claims are overly simplistic, however, as an operator's preference among jurisdictions is a function of the tax models, rates, and methods of collection—where the overall tax liability (primarily determined by rate) is the predominant factor. A deposit tax is more straightforward to calculate and enforce, reducing transactional costs and uncertainty in general. And the increased operator-side business risks involved with a deposit tax (mainly that funds might be deposited without being used for gaming, while still being taxed) can be mitigated by allowing operators to charge fees for early withdrawals, or by granting operators tax credits for customer account withdrawals.

Thus, the primary disadvantage of levying a deposit tax is that most established operators are accustomed to paying a GGR tax, which they perceive as less risky to themselves than being taxed on total gaming volume. Also, while unlikely in the real world, competitors or other malicious persons could "deposit" funds in an account and immediately withdraw the funds without activity, with the goal of causing economic injury to the operator. Even if operators are permitted to impose fees on customers for early customer account liquidation, that possibility alone may have the effect of deterring potential legitimate customers from using those operators' sites.

Operators and their associations lobby heavily to implement GGR tax models in countries proposing new online gambling legislation or already levying a turnover tax.[15] But as discussed, a licensed operator could be provided a full credit on the deposit tax for those funds withdrawn from player accounts at the end of each payment period. Such a method might thus be more accurately described as a "net deposit tax" model, and would mitigate the business risks and potential risks of unused or malicious deposits.

F. Hybrid Models

A few economically large jurisdictions such as Australia, Italy, and Spain use hybrids of the models described above.[16] Typically such hybrids involve structuring the licensure and taxation schemes by game type, where certain games may only be permitted under a monopoly model, others taxed on a GGR basis, others on deposit basis, and still others on a low-cost, license-only free market model. The primary advantage of creating a mixed approach to the regulation and taxation of online gambling is that it allows the regulator to mitigate the problem that different types of games flourish or suffer under different models. For example, when the United Kingdom shifted from a turnover tax to a GGR tax in order to slow the movement offshore of bookmakers, which was threatening gambling duty revenue as a whole, the imposition of a gross profits tax nevertheless led to reduced revenue in bingo and pools gambling.[17]

Thus, carefully crafted hybrid models can be used to maximize tax revenue according to the market dynamics of individual games, types of operators, or locality. And the advantages of each model incorporated into the hybrid can be potentially maximized. Of course, the higher transactional cost involved with a more complex hybrid model is the most obvious disadvantage. Furthermore, another detriment of adopting a highly complex hybrid model (especially one that may not adapt to changing market conditions flexibly enough) is that the jurisdiction's gaming industry as a whole may end up either more overburdened or under-taxed, cutting into overall potential license revenue.

Finally, the risks and disadvantages of each model are also potentially present in any hybrid system incorporating such a model. For example, a hybrid model incorporating a GGR tax will still require the regulator to collect at least some taxes in arrears, doing little to mitigate the problems outlined above in Section D. Ultimately, a model's structure should be crafted to balance these factors as the various market forces in a particular jurisdiction require.

III. APPLICATION OF REGULATORY AND TAXATION MODELS BY JURISDICTION

This Part of the Article provides a survey of certain jurisdictions' regulation and taxation of legalized Internet gambling, organized using the categorical approach described above. Monopoly models are used in Austria, Canada, Hong Kong, Hungary, Macau, the Netherlands, New Zealand, Sweden, and Turkey. Free market jurisdictions include Alderney, Costa Rica, the Isle of Man, Kahnawà:ke, and Panama. Belgium provides an illustration of a limited free market model jurisdiction with an emphasis on very limited licensure opportunities.

The surveyed jurisdictions utilizing a GGR model include Antigua and Barbuda, Curaçao, the Dominican Republic, Estonia, Greece, the Philippines, and the United Kingdom. Belize, Cyprus, France, Malta, and Poland use turnover tax models. Finally, Australia (including Tasmania), Denmark, Gibraltar, Italy, Spain and Vanuatu round out the sampling as hybrid model jurisdictions.

A. Monopoly Models

1. Austria

Regulated online gambling in Austria comprises all games of chance, including via telecommunications services such as the Internet and telephone.[18] The Ministry of Finance operates a state monopoly, Österreichische Lotterien, which is the only major licensed provider of online gaming services within Austrian territory, and is not permitted to provide extraterritorial services.[19]

There are a few exceptions from the state monopoly for low stakes betting and games of skill, but operators falling into the exceptions are regulated by the Federal States of Austria and their regional laws and can only accept Austrian players.[20] Interestingly, the supply of online gaming services by offshore operators is prohibited (as subject to the state monopoly) and offshore operators are not allowed to advertise or operate within Austria, but there is no penalty for Austrian citizens gambling on foreign sites and the government does not block or otherwise blacklist online gambling sites from other countries.[21]

2. Canada

A few provinces in Canada have set up state-run online gambling sites, with others considering following suit. The British Columbia Lottery Corporation ("BCLC") is the sole licensee in British Columbia to offer lotteries and other fixed odds games, casino gaming, and sports betting online.[22] For the fiscal year 2010-11, BCLC distributed C$1.104 billion to the provincial government.[23] Quebec provides similar offerings through Loto-Québec Corporation, generating C$3.675 billion in gross revenue, of which C$1.247 billion was paid directly to the provincial government.[24]

Likewise, Ontario is in the process of establishing an online casino offering a comprehensive assortment of games.[25] The casino is to be operated by a private company under strict regulation by the provincial government. As of this writing, the Ontario Lottery & Gaming Corporation is considering bids and will assess which operator is the most well-suited to deal with everything from design to financial transfers and all other aspects related to both lottery and online casino products.[26] Ontario regulators anticipate provincial revenue of about C$100 million per year within five years, to add to the roughly C$2 billion it receives through land-based casinos, lotteries, and bingos.[27]

3. Hong Kong

In the Hong Kong Special Administrative Region of the People's Republic of China, only pari-mutuel betting and the government lottery are permitted.[28] The Hong Kong Jockey Club is the only operator licensed to provide online gaming services to Hong Kong residents, and the betting duty paid by the Jockey Club accounts for about 10 percent of government revenues.[29]

In addition to live racetracks in Hong Kong, covered events include foreign horse racing and soccer. All other gambling is illegal in Hong Kong, and both operators and customers face stiff criminal penalties if convicted.[30]

4. Hungary

Hungary's state-owned Szerencsejáték has exclusive rights to provide lottery, sports betting, and prize draw ticket games—all of which are available online.[31] All other forms of Internet gambling are treated somewhat similarly to online gambling under the Unlawful Internet Gambling Enforcement Act ("UIGEA")[32] in the United States—that is, Hungary prohibits financial institutions from conducting transactions with offshore providers for the purpose of online gambling, but Hungarians do not face personal penalties for gambling online through offshore providers.[33]

5. Macau

Despite (or perhaps because of) its robust land-based gaming industry (with revenues over $33 billion in 2011[34]), Macau currently does not currently license online casino gambling.[35] But Macau permits pari-mutuel horse betting online through the only licensed online operator, the Macau Jockey Club, which pays a 35-percent tax on gross revenue. However, horse racing as a whole only accounts for slightly more than one-half of one percent of Macau's total gaming revenue.[36]

6. The Netherlands

The Netherlands is proposing to legalize online gambling fairly liberally, but currently operates online casinos, bingo, poker, and sports books under a government monopoly.[37] Its attitude towards offshore operators is quite negative, as illustrated by its implementation in 2008 of a blacklist of foreign internet sites with which Dutch banks are forbidden from doing business. This restriction is currently being challenged, with the European Union pressuring the Netherlands to move away from its state-operated monopoly.[38]

7. New Zealand

The Totalizator Agency Board ("TAB") and New Zealand Lotteries Commission are the only entities allowed to offer online gambling in New Zealand.[39] For the fiscal year 2010-11, the Lotteries Commission's online sales channel, MyLotto, generated about 5 percent of its NZ$925.9 million total sales (of which nearly 20 percent was returned to the Lottery Grants Board, which oversees distribution of funds to various community causes).[40] TAB's website saw a total turnover of approximately NZ$340 million in 2009-10.[41]

8. Sweden

The wholly government-owned Svenska Spel holds a monopoly over all gambling in Sweden, including online gambling—a policy which has survived criticism from the European Union as well as various challenges including a high-profile legal battle between the Swedish government and British bookmaker Ladbrokes.[42] But the government is rumored to be considering breaking the monopoly nevertheless, at which point Sweden would likely become a huge area of interest for offshore operators.[43]

9. Turkey

The state-owned IDDAA is the only Turkish entity permitted to offer online gambling services, and it only offers sports betting. As in many Middle Eastern countries, other gambling is strictly proscribed, both online and in land-based establishments.[44]

B. Free Market Jurisdictions

1. Alderney

Part of the British Channel Islands, Alderney offers several categories of licenses for remote gambling and extraterritorial Internet gambling servers.[45] Rather than taxing gaming deposits or revenue directly, there are two categories of license, with fees depending on the business type and size.

Category One licenses are for business-to-consumer operations, and the fee depends on the operator's annualized net gaming yield: for a license with no previous licensable activity in Alderney, the fee is £35,000; renewals by a licensee whose annualized net gaming yield is less than £1 million cost £35,000; where yield equals or exceeds £1 million but is less than £5 million, the renewal fee is £70,000; where it equals or exceeds £5 million but is less than £7.5 million, the renewal fee is £100,000; and renewals by a licensee whose annualized net gaming yield equals or exceeds £7.5 million cost £140,000.[46]

Category Two licenses are £35,000 per year and enable business-to-business gambling transactions, such as the operational management of the gambling platform.[47] Both forms of license provide tax-exempt status for the licensee, including from VAT or other sales taxes.[48] Temporary licenses are available for £10,000 per year, and carry the same obligations and privileges as a full license, but can be used for no more than 29 days continuously or 59 total days within a six-month period.[49]

Alderney asserts that "its regulatory and supervisory approach meets the very highest of international standards"[50] but the jurisdiction—like others offering extraterritorial licenses—has not been free from controversy. In April 2011, the U.S. Department of Justice directed the Federal Bureau of Investigation to seize the domain of Full Tilt Poker, operating under an extraterritorial license issued in Alderney at the time, calling it "a global Ponzi scheme."[51] Alderney responded by revoking Full Tilt Poker's license the following September.[52]

2. Costa Rica

Over two hundred Internet gambling sites base their operations in Costa Rica, which is popular for its permissive regulatory environment, robust infrastructure, and growing economy.[53] Because Costa Rica does not have a licensing regime specifically for online gambling, the jurisdiction merely requires a $15,000 corporate license fee with $1,500 quarterly renewals.[54]

Recently elected President Laura Chinchilla attempted a Fiscal Reform plan which would have imposed a 15 percent GGR tax on Free Trade Zone businesses (including Internet gambling operators),[55] but the plan was abandoned due to resistance from the Minister of the Presidency, the Costa Rican Association of Casinos, the Association of Call Center Employees, and the current political opposition party.[56]

3. Isle of Man

Like Alderney, the Isle of Man is a Crown Dependency of the United Kingdom and a popular jurisdiction for locating extraterritorial Internet gambling operations, with offerings including sports books, betting exchanges, online casino games, live dealing, peer-to-peer ("P2P") games, mobile phone betting, fantasy football (and similar games), pari-mutuel and pool betting, network gaming, lotteries, certain "spot-the-ball" style games, and network services.[57] Isle of Man's regulatory framework was established under the Online Gambling Regulation Act of 2001 ("OGRA"), which requires a license for included games, with some activities being exempt from licensure.[58] Fees include a £5,000 application fee and £35,000 for an annual license, which is granted for five-year terms.[59]

Exempted activities include the U.K. National Lottery, gambling covered by a Betting Office or Casino license,

spread betting, exempted activities defined by the Insurance Act of 1986,[60] free-to-play games, and ancillary services such as marketing, administration, information technology services, customer support, and disaster recovery facilities.[61]

4. Kahnawà:ke

Located in Quebec, Canada, the Kahnawà:ke Mohawk Territory provides a home to online casinos and poker rooms regulated by the Kahnawà:ke Gaming Commission.[62] The Commission currently issues four categories of license: an Interactive Gaming License awarded to a single data center within the Territory; Client Provider Authorizations ("CPAs") allowing each operator to use the single licensed data center; Secondary Client Provider Authorizations for operations located in another jurisdiction; and Key Person Licenses for managers of the Client entities.[63]

Application fees are C$25,000 for each CPA and C$5,000 for each Key Person, with annual licenses costing C$10,000 and C$1,000-C$2,500 respectively, plus a C$5,000 renewal fee being imposed every two years for CPAs.[64] 34 licensees are currently listed with the Gaming Commission, operating a total of 139 gaming sites.[65]

5. Panama

The operation of Internet gambling businesses in Panama is free of deposit or revenue taxes as long as the operator only accepts extraterritorial wagers—licensees may not accept business from Panamanians.[66] Furthermore, the Panama Gaming Control Board requires payment of a master license fee of $40,000, which is valid for up to seven years. Then an annual license fee of $20,000 applies, though master licensees may grant sub-licenses subject only to this annual fee.[67]

C. Limited Free Market Jurisdictions

Belgium provides a good illustration of the implementation of a limited free market model. Before 2012, the Belgian national lottery had an exclusive monopoly right to offer remote games. Enacted in 2011 and implemented January 1, 2012, the new Belgian Gaming Act permits very limited licensure of third-party operators.[68] Only three Internet gaming licenses have been granted so far—to PokerStars.be, Partouche.be, and Casino777.be.[69] The tax rate each operator is subject to differs by region, but as of late 2010 the Walloon government reportedly announced a flat tax of 11 percent on all online gaming volume.[70] The Gaming Act also criminalizes any participation in, advertising for, or recruiting for unlicensed games of chance—in effect, compelling internet service providers to block Belgians' access to unlicensed gambling sites appearing on a regularly updated blacklist.[71]

Greece and Poland are also in the process of licensing online gaming, and will likely issue only a limited number of casino licenses. Greece applies a fairly high GGR tax in addition to basic license fees,[72] and Poland has licensed a single operator subject to a variable turnover tax (depending on the game offered).[73] Spain, a hybrid model jurisdiction, has limited the licensure of cross-sports betting and horseracing mutual betting, which are subject to a variable GGR tax depending on the game.[74]

D. Licensing Fee Models with Gross Gaming Revenue Tax

1. Antigua and Barbuda

Now home to only 10 licensees,[75] the twin-island nation of Antigua and Barbuda saw a peak in online gambling revenues of nearly $2.4 billion in 2001 from 59 licensees—representing about 60 percent of the global online gambling market at the time.[76] This activity has since dramatically declined, in large part owing to the passage of UIGEA[77] in the United States and a subsequent dispute between the nations before the World Trade Organization.[78]

Currently, Antigua and Barbuda utilizes a GGR tax model at a rate of 3 percent of "net win" (synonymous with GGR), with operators being entitled to a maximum cap of $50,000 per month on taxes.[79] Additionally, operators can deduct software licensing and development costs up to 40 percent of their GGR, as well as charge backs on credit cards for up to 18 months after the original charge. Operators must maintain financial records and provide ready access to them to authorized government agencies. Gaming licensee fees are $75,000 annually and wagering licenses are $50,000 per year.[80]

2. Curaçao

Curaçao, a constituent country of the Dutch Kingdom since the dissolution of the Netherlands Antilles in October 2010, has adopted a fairly straightforward approach to online gambling regulation. Curaçao issues one type of license to cover a comprehensive assortment of gaming services, including all games of skill, chance, and sports betting. Company formation in Curaçao enables application for an "Ezone permit" to avail the operator of Curaçao's low 2 percent GGR tax and qualify for exemption from VAT.[81]

3. Dominican Republic

The Dominican Republic offers Internet casino and sports betting licenses.[82] Licensure requires a one-time payment of $15,000 in addition to a $15,000 application fee (or $10,000 if it is the second or third application), and the country imposes a 5 percent GGR tax with a $50,000 annual minimum thereafter.[83] While land-based casinos in

the Dominican pay the corporate tax of 25 to 29 percent plus fees based on the number of tables in operation and a gross tax on slot machine sales, offshore licensees are exempt from these taxes and levies as long as their revenue is not Dominica-sourced.[84]

4. Estonia

A relative newcomer to Internet gambling despite its robust land-based gambling industry, Estonia licenses operators to provide games of chance, games of skill, and pari-mutuel betting services.[85] The jurisdiction imposes a 5 percent sales tax that excludes player winnings.[86] Operators require two licenses: an activity license and an operating license, the issuance of which is the responsibility of the Estonian Tax and Customs Board.[87]

Per Estonian regulations, the country's internet service providers block offshore gambling sites that do not have an Estonian gambling license.[88] Although this policy runs counter to European Union policy, Estonian regulators claim that the situation is temporary, and only necessary in these early stages of online gambling development.[89]

5. Greece

The online casino industry in Greece is reportedly worth over €2 billion, a fact which, combined with Greece's current economic hard times, has deterred the nation from banning Internet gambling as it originally considered. Instead, it is now working towards a license-and-tax approach.[90] License fees have not been entirely settled upon, but legislation passed in August permits licensure of Video Lottery Terminals ("VLTs") and 10-50 online casinos, with rumors that fees will be approximately €15,000 per VLT and somewhere "in the order of €1-5 million" for five-year casino licenses.[91]

The Greek Finance Ministry originally intended to levy a 6 percent deposit tax on Internet operations, but has instead decided to implement a 30 percent GGR tax, which is toward the higher end of the scale for E.U. countries.[92] While the Remote Gaming Association was reportedly pleased with the switch, it has subsequently turned its energies towards convincing the Greek government to lower the GGR tax rate "to be more into line with other countries that have licensed remote gambling."[93]

6. Philippines

Although the Philippine Amusement and Gaming Corporation ("PAGCOR") held sole rights to all Internet gaming activities in the Philippines and had issued an exclusive license to one company—Philweb—until the year 2032, legislation passed in 1995 allowing the creation of the Cagayan Economic Zone Authority ("CEZA").[94] CEZA, also known as Cagayan Freeport, is a Philippines Tax Incentive Zone created with the goal of turning the Philippine province of Cagayan into a self-sustaining economic center.[95] Online casinos and sports books domiciled in the Economic Zone pay CEZA's special 5 percent gross income tax rate,[96] an Interactive Gaming License fee of $40,000, and a low 2 percent GGR tax.[97]

7. United Kingdom

The United Kingdom is the largest economy regulating Internet gambling under a GGR tax model.[98] Previously taxing turnover at 6.75 percent, which reportedly led a lot of bookmakers to move their telephone and Internet operations offshore, the British regulatory model currently imposes a 15 percent GGR tax on top of basic licensing fees.[99] Despite an 11 percent decrease versus the prior year due to operators moving offshore, gross online gambling yield in the United Kingdom was approximately $1.027 billion for the year ended March 31, 2010.[100]

Online gambling is regulated by the U.K. Gambling Commission, and includes remote casinos (providing games such as American roulette and blackjack, as well as P2P games like poker), remote betting, remote bingo, and remote lotteries.[101] Rather than offering a single Internet gambling permit, licenses are issued by game type and are either non-remote (that is, in-person) only, or allow remote operations from land-based premises.[102]

For example, operators wishing to provide general betting on virtual or real events via the Internet must pay an application fee from about £3,000 up to about £64,000 based on annual gross gambling yield (where for general betting, an annual gross yield of less than £500,000 qualifies the operator for the lowest rate, and the highest of seven tiers is represented by those operators generating an annual gross yield of over £500 million).[103] The annual remote betting license then costs from about £3,000 up to about £160,000 per year depending on annual gross gambling yield.[104] Remote casinos pay similar license application and annual fees, but remote lottery operators pay much less.[105]

E. Licensing Fee Models with Deposit/Turnover Tax

1. Belize

Belize licenses online operators to provide any type of gambling in compliance with the extraterritorial market being served.[106] The jurisdiction applies a turnover tax of 0.75 percent.[107] Extraterritorial licenses cost between $50,000 and $100,000,[108] and require being an International Business Company with incorporation in Belize, adequate capitalization, subjectivity to government audits, and

appropriate identity verification.[109] Furthermore, operators may not accept wagers from residents of Belize—that is, operators are granted extraterritorial licenses only.[110]

2. *Cyprus*

Previously a haven for online casino operators paying a relatively low 10 percent GGR tax, the Cypriot government has approved a bill that proposes to ban online gambling with the exceptions of sports betting and lotteries, which will be subject to a 3 percent turnover tax.[111] As in Belize, licenses require compliance with various criteria such as adequate capitalization and customer identity and age verification.[112]

3. *France*

The largest nation by GDP with regulated online gambling,[113] France imposes a 7.5 percent turnover tax on general gambling, horse racing, and sports betting, and taxes online poker at 2 percent of the amount wagered.[114] According to critics, these tax rates are "considered some of the highest in Europe."[115] For example, KPMG argues that France's adoption of a relatively high turnover tax and limited licensure model is overly burdensome on operators—decreasing competition and market value, as well as choice for consumers and tax revenue.[116] With reference to Italy's 20 percent GGR tax, KPMG estimated two years ago that by the end of 2012, Italy's gambling turnover will be approximately four times that of France, rendering France's gambling market "immaterial" by comparison.[117]

As predicted by critics of the French system, the French online gaming market has seen a recent decline in gambling revenue, as well as loss of market share in the European Union.[118] In response, and specifically in an effort to limit French gaming through offshore providers (and thus mitigate the associated loss of French gambling tax revenue), the French government has directed Internet service providers to block sites not licensed by the French online gaming regulatory authority ("ARJEL").[119] Furthermore, ARJEL expanded the number of licensed operators to 34 as of February 7, 2012.[120] And it must be noted that one of the reasons France legalized online sports betting in 2010—the FIFA World Cup—may have been a significant factor in the decline in sports betting in 2011, a possibility that critics tend to avoid highlighting.

4. *Malta*

Malta was the first member of the European Union to legalize and regulate online gambling through its Lotteries and Gaming Authority ("LGA").[121] For all practical purposes, Malta is a free-market jurisdiction with its low 0.5 percent turnover tax rate (with an annual cap, described below), low-tax onshore tax regime, and broad network of double-taxation agreements.[122] It licenses a comprehensive assortment of games under a four-tiered classification system: Class 1 licenses cover casinos; Class 2 licenses apply to fixed odds, pool, and spread betting; Class 3 includes P2P games (such as poker and betting exchanges); and Class 4 licenses are for operations managers and ancillary companies such as software vendors.[123]

After the costs of incorporating in Malta and a €2,330 application fee, a license of any of the four types only costs €7,000 per year for five-year terms, with a five-year renewal fee of €1,165.[124] Furthermore, the already low annual gaming tax is capped at €460,000. But casino licenses are subject to a "differential gaming tax" of €4,660 for each of the first six months, then €7,000 per month, and P2P operators are subject to an additional 5 percent tax on real income.[125]

5. *Poland*

Despite its well-established land-based casino industry, Poland has recently taken a very restrictive approach to online gambling, outlawing all gambling except sports betting sites, which pay a high 12 percent turnover tax.[126] Furthermore, though Poland does not characterize its model as a monopoly, Czech bookmaker Fortuna Entertainment Group is the only licensed operator to date.[127]

F. Hybrid Models

1. *Australia*

Australia's approach to Internet gambling is complex, particularly because each state and territory—like each of the United States—regulates its own gaming activities, subject to a few national restrictions. The Interactive Gambling Act ("IGA") generally restricts online gambling, making it unlawful for Australia-based operators to offer casino-style games such as roulette, poker, craps, or blackjack to anyone located in designated countries (that is, Australian jurisdiction), but excluding from the Act specific sports and race wagering, lotteries, and keno.[128] Thus, the IGA does not prohibit Australians from gambling with offshore providers, nor does it prohibit Australian operators from providing gambling services to extraterritorial customers.[129] Operators in Australian states and territories offer the activities excluded from the IGA—online sports betting, keno, and lotteries—to varying degrees, and subject to different regulatory models.

The Australian state of New South Wales has adopted a monopoly model for its regulated lottery, and a license fee model with graduated GGR tax for sports betting and keno. The state granted a forty-year exclusive lottery license to New South Wales Lotteries Corporation Pty Limited, a subsidiary of Tatts Group Limited, which pays 66.1 percent

of player loss in taxes.[130] Wagering on racing and sports is conducted by TAB Limited and licensed bookmakers, whose remote betting authorities are granted under New South Wales's Racing Administration Act.[131] Replacing the previously applied bookmakers' turnover tax, pari-mutuel sports betting is subject to a 19.11 percent tax on player loss, and fixed odds sports betting is subject to a 10.91 percent GGR tax.[132] Keno is taxed at 8.91 percent for the first A$86.5 million in player loss, and 14.91 percent thereafter.[133]

The Northern Territory accepts applications—without a fee—for an unlimited number of extraterritorial licenses to provide online gaming to offshore customers, subject to a low 4 percent GGR tax rate.[134] Bookmakers are taxed at 10 percent of gross monthly profit (replacing a turnover tax as of January 2010), which is capped at A$250,000 per year.[135] Online keno is subject to a 20 percent tax on gross profit.[136]

Adopting a monopoly model for remote gambling across the board, Queensland has granted a sole keno license to Jupiters Gaming Pty Ltd., a sole lottery license to Golden Casket Lottery Corporation, Ltd., and a sole wagering license to Tattsbet Ltd.[137] The government taxes at 20 percent of monthly commission on totalizators and fixed odds betting, 29.4 percent of monthly gross revenue after commissions from Jupiters (in addition to a A$195,900 quarterly license fee), 45 percent of monthly gross profit from Golden Casket (in addition to its A$195,900 quarterly license fee), 55 percent from instant scratch-offs, and 59 percent from soccer pools—all collected in arrears.

As is the case in each Australian jurisdiction, the only lawful online gambling is that which the federal Interactive Gambling Act does not prohibit. However, in South Australia, if there is no State law license, permit or authorization for the gambling, both the gambler and the gambling provider will commit an offence. So, not only can there not be any lawful Australian licensed internet casinos in this State, neither can there be any lawful off-shore internet gambling. The gambler in South Australia commits an offense and (to the extent that South Australian law can apply extra-territorially) so does the internet casino.[138]

The state of South Australia takes a more free-market approach, permitting anyone to apply for inexpensive lottery and bookmaker licenses. Bookmakers' licenses are available at relatively little cost. However, the licenses can only be granted to natural persons or to companies made up entirely of individual licensees. Commercial lotteries are a monopoly vested in a State owned statutory corporation (the Lotteries Commission), which will begin its online sales activity mid-year 2012.

Taxes on totalizators and sports betting by Australians will have been phased out by mid-2012.[139] Sports betting involving wagers accepted from extraterritorial customers is taxed at 0.25 percent of turnover.[140] The state lotteries, soccer pools, and keno operators pay 41 percent of net gambling revenue to South Australia's Hospitals Fund. However, each of these has to pay product fees to the racing industry of 10 percent of net wagering revenue (NWR), except for SA TAB, which has to pay 40 percent of NWR. (It should be noted that they all pay federal goods and services tax of one-eleventh of net wagering revenue, less product fees).[141]

The Australian island state of Tasmania authorizes the operation of race and sports betting, simulated (casino) games, lotteries, betting exchanges, and pari-mutuel wagering via telecommunications devices (including the Internet).[142] License costs are based on "fee units," where one unit is currently valued at A$1.40.[143] The application for a Tasmanian Gaming License is 30,000 fee units (unless reasonable costs exceed 30,000 units, in which case the Tasmanian Gaming Commission can charge the applicant with the excess amount).[144] License fees vary by gaming activity: for sports and race wagering, they cost 200,000 fee units; for lotteries and simulated gaming, they cost 300,000 fee units; and for betting exchanges and totalizators, they cost 350,000 fee units.[145]

Taxation of Tasmanian operators also depends on the gaming activity. There is no taxation on sports betting or race wagering operators after the initial license fee. Lotteries (the main outliers in an otherwise mostly GGR-oriented scheme) are taxed at 35.55 percent of turnover. Simulated gaming is taxed according to gross annual profit: the first A$10 million of gross profit is taxed at 20 percent; gross profit exceeding A$10 million up to A$20 million is taxed at 17.5 percent; and gross profit exceeding A$20 million is taxed at 15 percent. Additionally, gross profit relating to wagers made by residents outside of Australian territory is taxed at 4 percent. Betting exchanges pay 5 percent of commission received, and tote board operators pay a flat levy of 4.7 million fee units.[146]

For the fiscal year 2010-11, Tasmania collected less than A$2.5 million in Internet gaming and wagering taxes, a significant drop from previous years (about A$6.72 million in 2009-10 and nearly A$8 million for the previous year), mainly because of legislation lowering the betting exchange tax from 15 percent to 5 percent. But the state collected Internet gaming and wagering license fees of approximately A$1.5 million, a three-fold increase over previous years.[147] Lotteries (available online, but including land-based retailers) generated nearly A$84 million in tax revenue on slightly more than A$290 million in player expenditures.[148]

In Victoria, only Tabcorp is licensed to conduct online wagering.[149] Tabcorp and Tatts Group Ltd. formed a joint

venture to oversee Club Keno, which is operated by Tatts Group and pays 24.24 percent of player loss in taxes, subject to a minimum player return of 75 percent.[150] Separately, ten-year lottery licenses were awarded to Tatts Group and Intralot (each offering different lottery products), which both pay 79.4 percent of player loss (and are subject to a 60 percent player return requirement).[151] Sports betting is taxed at the same rates as in New South Wales.[152]

Finally, Western Australia's Lottery West operates the online lottery, which pays 40 percent of net subscriptions (sales less commission and prizes) to hospitals, 5 percent to the arts, 5 percent to sport, and 12.5 percent to eligible organizations.[153] Racing bet servicers have a choice between two methods of taxation: (1) a 1.5 percent turnover tax, or (2) the greater of a 20 percent gross profit or 0.2 percent turnover tax.[154]

2. *Denmark*

In contrast to Australia, Denmark's hybrid model is relatively simple. Denmark's state-owned operator, Danske Spil, holds a monopoly on online gambling licenses for horse racing and online bingo.[155] Other online sports betting and online casinos pay a 20 percent GGR tax, which prompted negative reactions from land-based operators, who pay between 45 percent and 71 percent GGR tax.[156] The lower tax rate for online operators was justified by the highly competitive nature of the international market in which they participate, compared to land-based operators' lower competition (being geographically restricted to Danish territory).[157]

3. *Gibraltar*

Gibraltar's regulatory model is divided between bookmakers and internet casinos. Bookmakers are subject to limited and strict licensing, and are taxed at 1 percent of turnover with an £85,000 annual minimum and £425,000 maximum. Licenses are renewable for only £2,000.[158] Internet casinos, on the other hand, are only subject to a 1 percent GGR tax (with the same minimum, maximum, renewal fee, and limited licensing as bookmakers).[159] The jurisdiction is generally not licensing new entrants, so along with strict prerequisites for licensure, online gambling licenses are very hard to come by. Extraterritorial services can only be directed at jurisdictions where such activities are not illegal.[160]

4. *Italy*

The third-largest surveyed nation by GDP, Italy had originally entered the online gambling market with a turnover tax ranging from 2.5 percent to 5 percent across the board.[161] Reacting to concerns from gambling operators and associations about competition in the European Union online gaming market, Italy introduced a GGR tax in 2010 at a rate of 20 percent for online casinos (after an initial license fee of €300,000 with lower renewals after each year of operation), and expects substantial growth as a result.[162] Despite this shift towards a GGR model, however, electronic lottery terminals, sports and horse race wagering, bingo, other lotteries, and games of skill are still taxed at a rate of 3 percent of total turnover.[163]

5. *Spain*

New regulation in Spain applies varying tax models and rates according to the type of gaming activity. Mutual sports betting, sports betting exchanges, horse racing counterpart betting, other mutual or counterpart betting, raffles, contests, and random combinations are regulated by a highly competitive bidding for licenses, and subject to a turnover tax varying from 10 percent to 35 percent depending on the game category.[164] However, cross-sports betting, horse racing mutual betting, and other games are taxed at 15 percent to 20 percent of GGR (or commission, in the case of P2P games), depending on the type of game.[165]

Generally speaking, Spain's newly enacted hybrid model emphasizes turnover tax as a method for regulating Internet gambling. The authors at KPMG point out that this runs counter to most European Union members such as the United Kingdom, Italy, and Denmark, as well as some Autonomous Communities within Spain itself, such as the Community of Madrid and Basque Country.[166]

6. *Vanuatu*

Providing an illustration of a relatively straightforward free-market-oriented hybrid tax model, the small island nation of Vanuatu also divides its model by game type. For general gaming, operators are subject to a 2.5 percent GGR tax with two licensing regimes: sports books pay an application fee of $35,000 and annual payments of $30,000; and other operators pay a $75,000 application fee and $50,000 annually. Fixed odds wagering is effectively free market, subject merely to the above licensing fees and a very low 0.1 percent turnover tax.[167]

IV. REGULATED ONLINE GAMBLING IN THE UNITED STATES

A. Current Regulation of Gambling in the United States

Of the fifty states and District of Columbia, only Hawaii and Utah outlaw all forms of gambling.[168] The U.S. gambling industry as a whole generated more than $92 billion in revenue in 2007 through commercial casinos, Indian casinos, state lotteries, and racetrack casinos.[169]

According to the American Gaming Association, commercial casinos currently operate in twenty-two states, generating a total gross casino gaming revenue of about $34.6 billion in 2010.[170] The 22 states with commercial casinos generally tax on GGR, from a low in Nevada of 6.75 percent,[171] up to 50 percent in Illinois and 55 percent on slot machines in Pennsylvania.[172] The exception is Maine, which applies a 1 percent turnover tax in addition to a 42 percent GGR tax.[173] A handful of states also apply a per-person, per-visit admission tax of $2 to $3, and South Dakota charges a $2,000 annual per-machine tax on gaming devices.[174] As a result of commercial casino revenue alone, these 22 states enjoyed a tax revenue in 2010 of more than $7.5 billion.[175]

Although traditional (land-based, dockside, or riverboat) gambling activities are governed by the states, Internet gambling implicates federal law. Applicable federal legislation is primarily found in the Wire Act[176] and Unlawful Internet Gambling Enforcement Act ("UIGEA"), although other federal and state statutes may also apply.[177] Specifically, the Wire Act provides:

> Whoever being engaged in the business of betting or wagering knowingly uses a wire communication facility for the transmission in interstate or foreign commerce of bets or wagers or information assisting in the placing of bets or wagers on any sporting event or contest, or for the transmission of a wire communication which entitles the recipient to receive money or credit as a result of bets or wagers, or for information assisting in the placing of bets or wagers, shall be fined under this title or imprisoned not more than two years, or both.[178]

Although it has long been thought by some that this section broadly prohibits Internet gambling,[179] a recent memorandum by the U.S. Department of Justice opines that the Wire Act is only applicable to betting in relation to sporting events or contests and does not prohibit states from operating lotteries online.[180] By extension, activities such as online poker and other games of skill, as well as casino games not involving sporting events, can be viewed as similarly outside the Wire Act's prohibitions.

On the other hand, UIGEA targets operators of gambling sites (as well as financial intermediaries) by prohibiting the acceptance of any financial instrument in connection with unlawful Internet gambling, which it defines as the interstate transmission of bets or wagers contrary to state or federal law.[181] Furthermore, several bills have been introduced in Congress that would authorize and provide for the licensure and taxation of online gambling operators.[182] Of note, the taxing schemes provided for in the proposed Internet Gambling Regulation and Tax Enforcement Act of 2010,[183] Internet Poker and Games of Skill Regulation, Consumer Protection, and Enforcement Act of 2009,[184] and Bipartisan Tax Fairness and Simplification Act of 2010[185] all provided for tax schemes (at various rates) based on "deposited funds"—that is, a license fee with deposit tax model.[186] Whether or not regulated online gambling becomes widespread in the United States may ultimately be dependent on state action and not federal action.

B. The Trend Toward Internet Gambling

Perhaps ironically, then, the first jurisdiction in the United States moving to legalize online gambling was not a state, but the District of Columbia. Its program "iGaming" was to offer online poker, blackjack and bingo through Greece-based Intralot, but the program was repealed before it launched, reportedly due to a lack of opportunity for public scrutiny.[187]

Of the states, Nevada appears to be leading the charge in legalizing online gambling by fast-tracking legislation to permit and regulate online poker between players. Proposed Nevada Gaming Commission regulation 5A.170[188] provides that gross revenue received by an establishment from the operation of interactive gaming is subject to the same license fee provisions as the games and gaming devices of the establishment, unless federal law otherwise provides for a similar fee or tax.[189] Specifically, operators would pay a license fee and monthly taxes based on gross revenue as in current land-based operation: 3.5 percent of the first $50,000 of monthly revenue; 4.5 percent of the next $84,000 of monthly revenue; and 6.75 percent of revenue exceeding $134,000 per month.[190]

In Florida, initially fervent attempts to legalize gambling in general and create a state Gaming Control Commission (primarily for the establishment of three large land-based casinos, but also through a set of regulations that would allow online gaming from internet cafes) have slowed, and the bill will not be seen again until the 2013 session, at the earliest.[191]

New Jersey's bill to allow for the operation of online casinos—as long their servers were located in Atlantic City—passed easily through the state legislature but was vetoed by Governor Chris Christie last year; Christie reportedly rejected the theory that server location restrictions would pass New Jersey's constitutional muster.[192]

Meanwhile in Iowa, State Senator Jeff Danielson plans to introduce a bill that would legalize online poker.[193]

And in California, lawmakers are considering legalizing online gambling for its claimed significant revenue potential, estimated by supporters at $100 million to $250 million per year.[194] The recently introduced "Internet Gambling Consumer Protection and Public-Private Partnership Act

of 2012" proposes legalization of intrastate gambling in California, with operators being required to make a $30 million up-front "use-it-or-lose-it" deposit against which subsequent monthly gross gaming revenue taxes would be drawn.[195]

V. *RECOMMENDATIONS AND SURVEY SUMMARY*

Perhaps the most obvious goals of legalizing and regulating online gambling are to provide consumer protection and the generation of tax revenue. Furthermore, the regulation of online gambling may reduce the prevalence of unlicensed or extraterritorially licensed operators. Jurisdictions considering the legalization and regulation of online gambling must structure their licensing and taxation models in such a way as to best achieve these goals. It seems likely that whether at the federal or local level, or across multiple jurisdictions, regulators will have to choose whether to adopt licensing fee regimes with a tax on either volume or profit—that is, a deposit tax or GGR tax. In addition, a high initial license fee, which should be credited as a deposit on taxes for a stated period of time, would help ensure the licensing jurisdiction has limited its financial risk through collections of taxes up-front. The central tax issue is therefore whether a deposit tax or GGR tax model would be more appropriate. As we have seen, there is a tension between the gaming industry preference for a GGR tax model and the regulatory preference for a deposit tax. While a GGR tax model seemingly tends to lower the business risk borne by operators, the timing of a deposit tax—as customers establish online accounts, as opposed to periodically calculated and collected in arrears—is preferable from a regulatory standpoint, and might make more sense in the context of online gambling.

A deposit tax is also more efficient because it is game neutral, as opposed to the calculation of GGR for operators offering a variety of game types. In the case of multi-jurisdictional regulation, a deposit tax is a tax on player funds where the place of residence or location of the player is readily identifiable, thus providing accountability and auditability advantages for the relevant locale. Calculations for operators are easy and transparent, as is verifying that they have paid the correct amount—reducing costs for both operators and regulators. Finally, a deposit model creates additional enforcement mechanisms by enabling regulators to impose the deposit tax liability (plus penalties) on players using unlicensed sites.

The "net deposit" model offers a neat compromise between pure volume-based and profit-based tax models. As discussed in Part II, operator concerns regarding a deposit tax are mitigated by giving tax credits for withdrawals from customer accounts (or customer withdrawals from accounts—for example, in the event that the customer has not played at all). This method lowers the perceived operator-side business risk and still allows regulators to collect fees as deposits are made, simplifying the regulatory system and lowering the costs involved for all parties. Alternatively, operators could charge a penalty for early customer account withdrawal or closure, but this may deter some customers from participating and could diminish the overall market to the detriment of operators and regulating jurisdictions alike.

On the other hand, a hybrid model might be developed—as illustrated by the large economies of Australia, Italy, and Spain. Certain gambling activities such as online casinos might be taxed according to a GGR model at a moderate rate, while others such as lotteries, bookmakers, and games of skill would not be inhibited by a net deposit model at a competitive rate. Despite their complexities, hybrid models could also be tailored for each specific jurisdiction. Different states have very different existing gambling markets, so each could adopt a model that suits its regulatory, economic, and social needs.

The five largest economies surveyed above in Part III have adopted different approaches to regulated Internet gambling. The largest, France, has adopted a turnover model at a rate of 7.5 percent across the board, but is arguably losing market share to other jurisdictions such as Italy and Spain. The United Kingdom has treated its online gambling market similarly to its land-based market through the application of a 15 percent GGR tax on top of a somewhat complex licensing regime. Canada (ranked fourth) prefers a monopoly model, where each Province operates its own gaming sites. Finally, Italy (ranked third) and Spain (ranked fifth) both utilize hybrid models with turnover and GGR taxes based on game category.

The following chart summarizes the survey:

Nation / State	GDP Rank[196]	Online Game Categories	Tax Model Summary
A. Monopoly Models			
Austria	12	Games of chance.	Government operator.
Canada	4	Provincial governments operate online lotteries, fixed odds, and casino games.	Government operator.
Hong Kong	15	Pari-mutuel betting and lottery.	Exclusive rights in Hong Kong Jockey Club.
Hungary	17	Lottery, sports betting, and prize draw ticket games.	Government operator.
Macau	21	Horse Racing.	Exclusive operator paying 35% GGR tax.
Netherlands	7	Online casinos, bingo, poker, and sports.	Government operator.
New Zealand	18	Totalizators and Lotteries only.	Government operator.
Sweden	11	Comprehensive.	Government operator.
Turkey	8	Sports betting.	Government operator.
B. Free Market Jurisdictions			
Alderney	N/A	Comprehensive.	License fees vary from £35,000 to £140,000 depending on revenue tier.
Costa Rica	20	Comprehensive.	$15,000 corporate and license fee with $1,500 quarterly renewals; no additional taxation.
Isle of Man	27	Comprehensive.	£5,000 application, £35,000 per year (for 5-year terms).
Kahnawake	N/A	Online casinos and poker rooms.	License fees only, no taxation.
Panama	22	Comprehensive.	Seven-year master license is $40,000; additional annual fee of $20,000.
C. Limited Free Market Model			
Belgium	10	Comprehensive.	Taxation (a reported 11% flat tax) per individual licensing agreements, very limited on a per-game basis.
D. Licensing Fee with GGR Tax			
Antigua and Barbuda	30	Comprehensive.	3% GGR tax (with a cap of $50,000 per month); gaming license is $75,000 annually and wagering license is $50,000 annually.
Curacao	26	Comprehensive.	2% GGR tax; monthly fee of about $5,000 for 2 years.
Dominican Republic	19	Comprehensive.	5% GGR tax with a $50,000 minimum, plus $15,000 license fee.
Estonia	24	Chance, skill, pari-mutuel betting.	5% sales tax plus licenses at the rates of: €48,000 for games of chance; €32,000 for games of skill; and €3,200 for tote boards.

Greece	14	Comprehensive.	30% GGR tax. VLT licenses are about €15,000 ea.; and limited online gaming licenses will be somewhere in the order of €1-5 million for a five-year term.
Philippines	16	Casinos, sports books, sports betting.	5% corporate tax and 2% GGR tax, plus a range of licensing fees.
United Kingdom	2	General betting, bingo, pools (licensed brick and mortar operators).	15% GGR tax.
E. Licensing Fee with Turnover Tax			
Belize	28	Comprehensive.	0.75% turnover tax.
Cyprus	23	Sports betting and lotteries.	3% turnover tax.
France	1	Comprehensive.	7.5% turnover tax.
Malta	25	Comprehensive.	0.5% turnover tax.
Poland	9	Casino games by Fortuna.	2-45% turnover tax, depending on the game (only one licensee so far).
F. Hybrid Models			
Australia	6	Online wagering, lotteries, and keno.	Complex hybrid model with differing models and rates by states and territories.
Denmark	13	The state-owned monopoly, Danske Spil, holds the sole online gambling licenses for horse racing and online bingo. Online sports betting and casinos licensed on limited basis.	Hybrid 20% GGR tax for online casinos and online sports betting, and state monopoly over horse racing and bingo.
Gibraltar	29	Bookmakers:	1% turnover tax capped at £425,000 annually; minimum gaming tax £85,000 annually. Licenses renewable annually for £2,000.
		Internet casinos:	1% GGR tax; similar caps and fees.
Italy	3	Online gambling, with exceptions below:	20% GGR tax.
		VLTs, sports and horse racing, bingo, lotteries, and games of skill:	3% turnover tax.
Spain	5	Mutual sports betting, sports betting exchange, horseracing counterpart betting, other mutual betting, other counterpart betting, raffles, contests, random combinations:	10-35% turnover tax depending on the game; limited licensure.
		Cross-sports betting, horseracing mutual betting, other games:	15-20% GGR tax depending on the game; limited licensure.
Vanuatu	31	General gaming:	2.5% GGR tax. $35,000 application plus $30,000 annually for sports books; other operators pay $75,000 application plus $50K annually.
		Fixed odds wagering:	0.1% turnover tax, plus above license fees.

ENDNOTES

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2. "Offshore gambling" as used throughout this chapter is gaming activity by a customer geographically located within a particular jurisdiction through an operator based outside of that jurisdiction.

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The Franchise Tax Board Gets More "Firm" About Collecting Delinquent Taxes

By Joseph P. Wilson & Joyce E. Cheng.[1]

I. INTRODUCTION

The California Franchise Tax Board ("FTB") has new legislation at its back, which significantly expands its reach in the collection arena for delinquent taxes and certain non-tax debt of individuals and business entities. This new legislation, codified at California Revenue and Taxation Code section 19622[2], authorizes the FTB to operate and administer a Financial Institution Records Match ("FIRM") that utilizes automated data exchanges to identify accounts of delinquent tax debtors[3] held at financial institutions[4] doing business in California. The FIRM data exchange is generally intended to be similar to the Financial Institution Data Match ("FIDM") program, which is operated for purposes of child support collection.

Current state law authorizes the FTB to use several collection tools in order to collect delinquent tax liabilities, one of which is an Order to Withhold ("OTW").[5] An OTW can be issued to any third person in possession of funds or properties belonging to a tax debtor. For purposes of this discussion, this paper limits the third person to a depository institution. Upon receipt of an OTW, the depository institution notified is required to freeze the tax debtor's assets in its possession and hold those assets for not less than 10 days, and then remit to the department all cash or cash equivalents held that will satisfy the amount of the OTW. The goal of FIRM is to locate the financial accounts held by delinquent tax debtors for the purpose of issuing OTWs in the hope of satisfying delinquent tax accounts.

II. THE PROGRAM

A. The Quarterly Data Match Process

Revenue and Taxation Code section 19266 authorizes the FTB to implement a quarterly data match process to match specified debtor data against accountholder information of financial institutions doing business in California. Informatix, Inc. ("Informatix") has been contracted as the FIRM Program Administer ("PA"). Informatix is to manage the day-to-day operations of the FIRM program, administer the quarterly data exchange, and provide customer service, education and outreach services to financial institutions regarding the FIRM program.

The FTB targeted the first data exchange for purposes of matching tax debtor records, for a date no earlier than April 1, 2012. However, the statute was not operative until 120 days after January 1, 2012 (or April 30, 2012), and only applies to persons that are delinquent tax debtors on or after that date. As part of the first phase, Informatix notified approximately 180 financial institutions of their required participation in the first quarterly FIRM data match program commencing in April 2012. In the second phase, Informatix will be contacting additional financial institutions for their required participation in the second quarterly match of the FIRM program. The FIRM program will be rolled out over several quarters. The FIRM PA will work with each financial institution to ensure their questions are addressed. FIRM PA Informatix, Inc. can be reached by phone at 866-576-5986, or by email at zCATAX@informatixinc.com.

B. Reporting Methods

Essentially, financial institutions have two methods to report the required information to the FTB. "Method One" involves the financial institution submitting a data file via the internet to the FIRM PA that contains records of all open accounts held by the financial institution. Submitted files are matched against the FTB delinquent tax debtor file by the FIRM PA. Transmissions for subsequent quarters contain records regarding accounts opened, closed, or changed during a particular quarter.

"Method Two" works in the reverse. The financial institution, or its transmitter, is to retrieve a downloaded delinquent tax debtor file via the internet from the FTB. The onus is then on the financial institution to match the FTB list against all open accounts maintained by the financial institution, and to submit a file of matched records to the FIRM PA. According to the participation schedule, the FTB data files will be available 15 days after the close of the calendar quarter with reports due to the PA approximately 45 days later regardless of the method used.

Pondering one of life's polarizing questions, "Is it better to give than to receive?", at first glance it seems that giving

may be better than receiving in the case of the FIRM program. The requirement to submit a list of accounts to the FTB under Method One leaves the heavy lifting to the FTB (or the PA) to do the actual matching. Method Two places the administrative burden on the financial institution to perform the actual matching of the FTB records against its accountholders and in turn submit a report of positive matches to the FTB PA. However, a financial institution can select Method One only if it does not have the technical ability to process the data exchange or the ability to employ a third-party data processor to process the data exchange. Also, Method One requires that the financial institutions provide the FTB (or the PA) an entire list of all open accounts. This raises serious concerns regarding confidentiality and what controls exist to safeguard these accounts once the information is transmitted.

It is not clear what, if any, additional information the financial institutions will be transmitting beyond the matching of debtors to open accounts. A review of the FIRM General Information Booklet[6] indicates that the "record layout" for the information to be transmitted by the financial institution is deemed confidential and is purposely removed from the booklet. A written request may be submitted, stating the appropriate business need, to the FTB FIRM liaison.

III. THE PLAYERS

There are essentially three categories of "players" in the program: financial institutions doing business in California, the FTB and/or the PA, and delinquent tax debtors.

A. Financial Institutions

Although there is temporary exemption available if the financial institution holds less than 250 open accounts and submits a Temporary Exemption Request to the FIRM PA, the FIRM requires that all financial institutions participate in the program. The definition of a financial institution is not as straightforward as one might expect. "Financial institutions" include a depository institution,[7] such as a savings bank, commercial bank, savings and loan association, or credit union; an institution-affiliated party,[8] which includes any director, officer, employee, or controlling stockholder (other than a bank holding company or savings and loan holding company) of, or agent for, an insured depository institution; a federal or state credit union[9]; a benefit association (homeowners associations, California State Employees Association, etc.); insurance company; safe deposit company (safe deposit box rental companies); money-market fund, or similar entity authorized to do business in this state.

According to section 23101 of the Revenue and Taxation Code, a financial institution is "doing business" if it is actively engaging in any transaction for the purpose of financial or pecuniary gain or profit. The breadth of this definition calls into question a number of issues. For example, if a financial institution has branches in different states, will the financial institution be required to match accountholder information from those branches? Will out of state banks with an ATM in California have sufficient nexus to put the bank within the jurisdiction of California? What if the fees are cleared through a clearing house? The draft regulations specifically include that the financial institution or its transmitter is to match the FTB Inquiry File against all open accounts maintained by the financial institution, regardless of the residence of the accountholder.[10]

If a financial institution is doing business in California, it needs to know which types of financial accounts are subject to reporting under FIRM. These include, but may not be limited to, demand deposit accounts, share or share draft accounts, checking or negotiable withdrawal order accounts, savings accounts, time deposit accounts, and money market mutual fund accounts.

Unless otherwise required by law, a financial institution is prohibited from disclosing to a depositor or accountholder the name, address, social security number, or other identifying information of that delinquent tax debtor that has been received by, or furnished to, the FTB.[11] Therefore, the financial institutions need to be careful to determine what other laws are applicable in order to determine whether the financial institution has a legal obligation to disclose information received from the FTB or furnished to the FTB to the accountholder. Although Section 19266(e) explicitly states that a financial institution shall incur no obligation or liability to any person arising from furnishing the information to the FTB and by not informing the person of the disclosure, there may be other relevant federal laws (or conflicting state laws) that trump this statute under the Supremacy Clause.[12]

B. FTB/Firm Program Administrator

As previously mentioned, Informatix has been contracted as the FIRM PA to manage the day-to-day operations of the FIRM program. The FTB has to provide the source data to allow the financial institutions to conduct their matching functions. According to FIRM, the FTB provides, on a quarterly basis, the financial institutions with the name, record address and other addresses, social security number or other taxpayer identification number, and other identifying information for each delinquent tax debtor, as identified by the FTB by name and social security number. Therefore, unless the amount of the tax debt itself is used to

identify the tax debtor, the statute does not allow the FTB to provide the financial institutions the specific amount of the delinquent debt owed by the accountholder/debtor. Generally, this information is protected from disclosure under section 6254.21 of the California Government Code, except that the FTB does make available as a matter of public record at least twice each calendar year a list of the 500 largest tax delinquencies in excess of one hundred thousand dollars ($100,000). The first data file was limited to 600,000 tax debtor records. It may be increased by no more than 600,000 greater than the number of data record files included in the immediate preceding data file until all are included.

C. Delinquent Tax Debtors

The delinquent tax debtor is the third participant, albeit unknowingly, in the program. A delinquent tax debtor includes any person liable for any income or franchise tax or other debt referred to the FTB for collection including tax, penalties, interest, and fees, where the tax or debt, including the amount, if any, referred to the FTB *for collection remains unpaid after 30 days from demand for payment* by the FTB.

"Person" includes individuals, persons responsible for vehicle license fees, entities, including Limited Partnerships, LLCs, Foreign Limited Liability Partnerships, Professional Corporations, S Corporations, Banks, and Fiduciaries.[13] Based on the very broad definition of "delinquent," questions may arise about whether FIRM encompasses tax debtors who already have sought other collection alternatives such as installment agreements, offers in compromise, or who are in uncollectible status or have filed bankruptcy. Where does FIRM leave those taxpayers?

1. Installment Agreement

Tax debtors that are currently in an installment agreement with the FTB are not subject to the matching process. However, if the tax debtor is not making current timely installment payments on the liability under an agreement pursuant to Revenue and Taxation Code section 19006, the tax debtor will be subject to the matching process.

2. Bankruptcy

The broad definition of "tax debtor" does not appear to exclude tax delinquencies that are the subject in an active bankruptcy proceeding, nor to exclude tax delinquencies for which the FTB has verified that a bankruptcy proceeding has been completed and no assets exist with which to pay the delinquent amount or amounts. Consider that in United States bankruptcy law the filing of the bankruptcy petition creates an automatic injunction that halts actions by creditors, with certain exceptions, to collect debts from a debtor who has declared bankruptcy.[14] The FIRM system is a method of collection. Therefore, actions taken by the FTB to include these tax debtors on the FIRM list could reasonably be argued to be a violation of the automatic stay.

3. Offer in Compromise

It is unclear whether in the case where an offer in compromise is pending, but there is no installment agreement, if the FTB will place the delinquent tax debtor on the matching list, and if so, at what point in time. This remains to be seen. It seems logical for the FTB to do so in order to confirm the veracity of the financial statement submitted with the offer in compromise, which requires disclosure of all bank accounts including Savings & Loans, credit unions, CDs, and IRAs.[15]

4. Uncollectable Status

Tax delinquencies that the FTB has determined to be uncollectible also do not appear to be excluded from the definition of tax debtor. The concern here is whether a positive FIRM match will reactivate an uncollectible account and subject the tax debtor to an automatic OTW without any substantive review.

5. Non-Collectable Accounts

The definition of "tax debtor" presumably does not include tax delinquencies that are no longer collectable based on the statute of limitations because these debts would no longer be referred to the FTB for collection purposes.[16]

IV. THE POTENTIAL PROBLEMS

A. Confidentiality of Taxpayer Information

The financial institution and its transmitter are charged with protecting the confidentiality of the FTB Inquiry File and any data and records supplied to the financial institution by the FIRM PA. The Right to Financial Privacy Act, Gramm-Leach-Bliley Act, and the California Right to Financial Privacy Act confer upon banks a continuing obligation/responsibility to safeguard customer information. Section 19266(b) indicates that the FIRM program is not subject to any limitation set forth in California Government Code section 7460 *et seq.*

Pursuant to Revenue and Taxation Code section 19266, any use of the information provided for any purpose other than the collection of franchise or income tax, or other nontax debts referred to FTB for collections, is a violation of Revenue and Taxation Code section 19542.[17] This provision applies to actions made on behalf of the FTB. Moreover, Section 19266(e) explicitly states that a financial institution shall incur no obligation or liability. However,

the fact that legislation provides protection does not prevent problems from arising.

There are inherent potential problems of this confidential information being provided to thousands of financial institutions by the FTB and through a third party PA. This information includes the tax debtor's name, record address and other addresses, social security number or other taxpayer identification number, and other identifying information for each delinquent tax debtor. This information is to be transmitted to both small and large financial institutions, including insurance companies and other non-traditional financial institutions. Some of those institutions may have adequate procedures in place to safeguard and protect this information. Other smaller and less traditional financial institutions may not, increasing the risk associated with misappropriation of personal tax debtor information.

B. Collateral Consequences to Debtor/ Accountholders

The FIRM Program will certainly raise revenues for the State of California, which revenues without a doubt are sorely needed. From a revenue raising standpoint the program should be a great success. However, collateral consequences do appear to exist for the debtor/accountholder. After the FTB has the matching information and proceeds to issue an OTW to the financial institution, a financial institution may decide to no longer do business with that accountholder as a result of the added burden and cost of processing collections for the FTB. Financial institutions doing business in California may also become more cautious regarding their procedures for opening accounts and be less inclined to allow depositors who are on the delinquent tax debtor list to establish an account. Also, trust companies and other institutional fiduciaries may have additional administrative burdens when making distributions to beneficiaries. Banks serving the trusts may require full disclosure of the identifiers for all beneficiaries. The same may apply for pension plan administration. Once financial institutions learn about the delinquent debtors with accounts at their financial institution, said institutions may be unwilling to do business with these people or businesses. This could affect business lines of credit, qualification of mortgage loans, and the ability for businesses to do business in California. These are some of the collateral issues that should be monitored.

C. Cost of Compliance and Non-Compliance

Although the FIRM Program unilaterally creates an administrative and financial burden on the financial institutions to match records and disclose this information to the FTB, it does provide for a limited amount for reimbursement of one-time startup costs in an amount up to $2,500 for each financial institution, and provides for reimbursement for the quarterly data matches conducted in an amount up to $250 per quarter per financial institution. According to *www.BankingDetail.com*, there are allegedly 7,374 FDIC "banks" currently in California. Taking that statistic at face value, if each of those banks were to request and qualify for the maximum start-up costs, the bill would be $18,435,000. Thereafter, quarterly reimbursements would be $7,374,000 per year. And that doesn't include all the other "financial institutions" as defined under FIRM. Informatix has only contacted approximately 180 financial institutions in the initial phase of this program.

Undoubtedly this program will grow. The FTB has projected the total project plus program costs for 2012 to be approximately $1,251,901, with an estimated revenue impact of $37,000,000. At a recent FTB interested parties meeting, an FTB representative stated the OTW process with respect to financial institutions will remain unchanged and anticipated that once the first FIRM data exchange was completed in April and May 2012, the FTB will begin to issue levies sometime in June 2012.[18] The first quarter record matches have been completed and the next step is to issue OTWs against those delinquent debtors that have failed to resolve the outstanding liabilities due to the state. In this next fiscal year, the FTB expects to issue more than 475,000 OTWs, an increase of approximately 75 percent over last year. Financial institutions can expect the increase in OTWs throughout the year.

1. Penalties for Non-compliance

Like a horse and carriage, a penalty always follows a tax and the FIRM Program is no exception. The FTB may institute civil proceedings against financial institutions to enforce Revenue and Taxation Code section 19266(f). Under the FIRM Program, any financial institution that willfully fails to comply with the rules and regulations promulgated by the FTB for the administration of delinquent tax collections may be subject to a penalty. The penalty under the FIRM Program is fifty dollars ($50) for each record not provided. The total penalty may not exceed one hundred thousand dollars ($100,000) during any calendar year. The FTB will issue a notice and demand and the penalty will be collected in the same manner as tax.

An exception to the penalty exists if the financial institution can demonstrate to the satisfaction of the FTB that the failure is due to reasonable cause. The definition of willful as used in this section in not clearly defined. However, the use of the term "willfully" connotes that the legislature intended the standard of non-compliance to be higher than that of "negligence." Willfulness is generally

the voluntary, intentional violation of a known legal duty. A good faith misunderstanding of the law or good faith belief that one is not violating the law negates willfulness. If the penalty is asserted, the FTB has the ability to assess the penalty and simply issue a Notice of Demand. When the FTB imposes a delinquent filing or notice and demand/ failure to furnish information penalty, the law presumes that the penalty has been imposed correctly.[19] Therefore, it remains to be seen whether the same presumption will apply in this context, placing the burden on the financial institution to prove the failure is due to reasonable cause.[20]

2. *Penalty Relief*

The *burden of proof* will likely be on the Financial Institution to show reasonable cause. In order to overcome the presumption of correctness of notice of demand penalties, the taxpayer must provide credible and competent evidence to support the claim of reasonable cause; otherwise the penalties will be not be abated.[21]

Reasonable cause may exist if the financial institution demonstrates that it qualifies under the temporary exemption examples, such as holding less than 250 open accounts and submission of a Temporary Exemption Request to the FIRM Program, but that such submission has not yet been processed.

Reasonable cause may exist in a situation where Financial Institution B had just merged with Financial Institution A and the institutions are undergoing a major data processing change at the end of a quarter. Financial Institution A (the surviving financial institution) can apply to the FTB for a Temporary Exemption Request stating that the additional cost to participate in the data match for that quarter would be significant and not cost effective. Based on these facts, the FTB may grant a temporary exemption for one quarter, and possibly may consider this fact scenario for purposes of reasonable cause.

Reasonable cause may exist if the financial institution would have qualified for temporary suspension on the regulations, but due to unforeseen circumstances was unable to submit its application in a timely matter. In this situation, the financial institution would probably need to provide the FTB with a written notice from its supervisory banking authority that establishes that the financial institution is undercapitalized, significantly undercapitalized, or critically undercapitalized as defined by FDIC Regulation 325.103(b)(3), (4), and (5), or NCUA Regulation 702.102.

Reasonable cause may also exist if the failure to match the data is caused by the transmitter and not the financial institution, and the financial institution is able to adequately provide substantiation of that fact.

D. Cross-Agency Communications

State taxing agencies (FTB, Employment Development Department ("EDD"), Board Of Equalization ("BOE")) already have access to certain information across agencies but the question is whether or not FIRM will open the channels to include the matching information obtained.

The FIRM program is not subject to any limitation set forth in California Government Code section 7460 *et seq.* (California Right to Financial Privacy Act). However, any use of the information provided pursuant to Revenue and Taxation Code section 19266 for any purpose other than the collection of franchise or income tax or other nontax debts referred *to FTB for collections* is a violation of Revenue and Taxation Code section 19542.[21] Pursuant to Revenue and Taxation Code section 19005(b), it is a misdemeanor for the FTB or any member, deputy, agent, clerk, or other officer or employee of the state (including its political subdivisions), or any former officer or employee or other individual, who in the course of his or her employment or duty has or had access to returns, reports, or documents, to disclose any information as to the amount of income or any particulars (including the business affairs of a corporation) contained in those records.

It does not appear based on a strict reading of the statute at Section 19560.5 that the information transmitted under FIRM can be shared with local taxing authorities or other creditors, including the IRS, at this point in time. However, the 2012/2013 Governor's Budget has extended FIRM to the EDD and the BOE. The FTB has already met with these departments to discuss planning efforts and timeframes needed to incorporate their data into the FTB's delinquent debtor file. In June 2012, the FTB stated that it was prepared for BOE and EDD participation in the FIRM program as early as January 2013.

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While California is a progressive state, the fact is other states have already implemented similar matching programs. Laws in Indiana, Kentucky, Maine, Maryland, Massachusetts, Minnesota, New York, New Jersey, and North Carolina provide the revenue departments of those states authority to use a financial institution record match process for the collection of delinquent income taxes. An analogy can also be made between FIRM and the federal matching program under the recently enacted Foreign Account Tax Compliance Act ("FATCA").[22] FATCA requires financial institutions that have U.S. investments to enter into agreements with the IRS that provide that the financial institutions will search their records and provide record information to the Internal Revenue Service for all customers who are U.S. persons. FATCA is in essence a

class reporting system as opposed to an individual reporting system. The class in question is all U.S. persons with accounts in a foreign financial institution. A record match system may occur later when the IRS compares FATCA reports with income tax return disclosures required under new IRC section 6050D. At any rate, both the State of California and the federal government are now using record matching programs with financial institutions to widen their enforcement nets in order to snare additional tax revenues.

VI. CONCLUSION

The FIRM Program will certainly raise revenues for California, which revenues without a doubt are sorely needed. From a revenue-raising standpoint, the program should be a great success. The capture of this income does have its costs, including the costs of administration, collateral issues to the banking/finance industries doing business in California, and privacy concerns to tax debtors, including the potential for identify theft abuses. As the FIRM program progress, it remains to be seen how these issues will be resolved. One thing for sure is that the playing field between delinquent tax debtors and the FTB is no longer the same.

ENDNOTES

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2. S.B. 68, Ch. 14, chaptered March 24, 2011.

3. Rev. & Tax. Code § 19266(h)(3).

4. Rev. & Tax. Code § 19266(h)(2).

5. Rev. & Tax. Code § 18670.

6. *See*, FTB, https://www.ftb.ca.gov/businesses/FIRM_Financial_Institution_Record_Match/index.shtml#Forms

7. 12 USC § 1813(c).

8. 12 USC § 1813(u).

9. 12 USC § 1752.

10. Draft Regulations § 19266(d)(2)(B).

11. Rev. & Tax. Code § 19266(d).

12. *See* the Right to Financial Privacy Act and Gramm-Leach-Bliley Act, 15 USC, Subchapter I, §§ 6801-6809.

13. Rev. & Tax. Code § 19266 (b), referencing collection as imposed under Part 5 (commencing with Rev. & Tax. Code § 10701), Part 10 (commencing with Rev. & Tax. Code § 17001), Part 10.2 (commencing with Rev. & Tax. Code § 18401), or Part 11 (commencing with Rev. & Tax. Code § 23001).

14. 11 U.S.C. § 362.

15. FTB 4905 PIT Offer in Compromise Form.

16. Rev. & Tax. Code § 19255 (FTB generally has a 20-year collection period from date liability becomes due and payable). *See* Rev. & Tax. Code § 19266(h), (e).

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Gliding Off the Fiscal Cliff Towards Taxmageddon

By Mark S. Hoose & Laura Buckley[1]

I. INTRODUCTION

Depending upon whom you ask, the United States is either headed towards a "fiscal cliff" or "taxmageddon."[2] Either way, the prospects are not good. This dire future is due to a combination of factors, perhaps most importantly the 2008 financial crisis and resulting recession. However, recent tax policy missteps have contributed to the issue, including the temporary extension in 2010 (through the end of 2012) of the 2001 tax rate reductions, the automatic spending cuts that were enacted as part of the "debt ceiling" standoff in the summer of 2011, and the temporary (through the end of 2012) reduction in the payroll tax rate.

Hence, without further Congressional action, income tax and payroll tax rates will rise and automatic spending cuts will begin in January 2013, endangering a fragile economic recovery. After a brief review of how we got to this point, this article will then discuss the prospects for avoiding the fiscal cliff/taxmaggedon.

II. BACKGROUND – 2010 LEGISLATIVE CHANGES AND ELECTION

A. The Legislative Environment

The so-called "Bush-era tax cuts," passed in 2001 and 2003, were set to expire on December 31, 2010, because they were passed as part of a budget "reconciliation measure" (since the Republicans only had a slight majority) which cannot be filibustered.[3] A bill can only be pushed through by reconciliation, however, if it would *not* add to the deficit at the end of ten years; thus, the "sunset" provision in the Bush-era tax legislation meant that the deficit was calculated as if the higher tax rates would be in effect January 1, 2011 (interestingly, this was the same vehicle used to pass the recent health care bill).[4] In short, if Congress and President Obama did nothing, the Bush-era tax cuts would go away automatically on December 31, 2010, and the 2001 rates would resurrect immediately.[5] According to the White House, the average American would have seen an immediate tax increase on January 1, 2011, of $3,000.[6]

Democrats have long argued that the Bush-era tax cuts *should* go away, and President Obama vowed to end the tax cuts for the wealthy during his election campaign.[7] But after enjoying control of both the Senate and the House—which allowed the enactment of the Patient Protection and Affordable Care Act ("Obama health care bill")—the Democrats faced the 2010 midterm Congressional election where all seats in the House of Representatives and one third of Senate seats were up for election.[8] In fact, many Democrats were concerned that even the safest Senate seats (such as that of the late Edward M. Kennedy of Massachusetts) would go to a Republican as a direct political consequence of the Obama health care bill.[9]

The fears were not unwarranted; the Republican Party picked up six seats in the Senate (which became 53 Democrats, including two independents, and 47 Republicans), and more than 60 seats in the House (which became 240 Republicans to 193 Democrats). Thus, the Senate became gridlocked, Republicans assumed a majority in the House, and consequently Representative Dave Camp (Republican from Michigan) became Chairman of the Ways and Means Committee, which has sole jurisdiction over United States tax policy.[10] Representative Camp prides himself on "lowering and simplifying tax rates for individuals, families, and employers."[11] In other words, a major power shift occurred after the midterm Congressional elections and the stage was set for an epic battle.

B. 2010 Legislative Changes

Facing expiration of the Bush-era tax cuts, President Obama signed the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 ("2010 Tax Relief Act") on December 17, 2010.[12] The 2010 Tax Relief Act extended the Bush-era tax cuts on individual ordinary income rates (35 percent top rate, as opposed to 39.6 percent if allowed to expire) and capital gains/dividend tax rates (15 percent) for all taxpayers until December 31, 2012.[13] Additionally, the 2010 Tax Relief Act provided for an alternative minimum tax "patch," a payroll tax cut (for one year), 100 percent bonus depreciation (through 2011) and 50 percent bonus depreciation (for 2012), a 35 percent cap on the estate tax rate with a $5,000,000 exclusion, and more.[14]

Critics concluded that the Democrats punted on the tax-cut issue because they feared further backlash from

voters.[15] Moreover, President Obama faces a re-election campaign in 2012. Although he earlier vowed to end the tax cuts, President Obama personally placed numerous calls to House Democrats in December 2010 urging them to support the extension of the cuts.[16] Representative Elijah Cummings (Democrat from Maryland) voiced his concerns to President Obama in 2010 that "these tax cuts would not end in 2012, because in an election year, [it is] very, very difficult" to increase taxes; President Obama replied that the Bush-era tax cuts "would be part of his platform when he ran."[17]

If no further action is taken, the Bush-era (or the Obama-era) tax cuts will officially expire on December 31, 2012, and rates will automatically increase on January 1, 2013.[18]

III. THE DEBT CEILING STANDOFF

As 2011 began, Congressional Republicans decided to test their new power almost immediately by publicly proclaiming that they would not vote to increase the federal government's "debt ceiling," which was due to be exceeded by early August, 2011. The government's debt ceiling is an arcane rule that limits the ability of the U.S. Treasury to borrow without further Congressional authorization. For many years, Congress has voted to increase this ceiling without significant controversy.[19] Congressional Republicans stated that they would not approve this particular increase without significant changes to the government's fiscal policy. [20]

This stated refusal caused much confusion in financial markets, and immediately led to speculation as to whether the two political parties could agree to a solution. Evidently, high level negotiations between Democrats (including President Obama) and Republicans (led by House Speaker John Boehner) took place in July 2011, and came very close to agreeing on a framework of a budget deal that would include tax revenue increases and significant spending cuts in the context of an overall change to federal tax policy.[21]

However, this comprehensive deal never came to pass, and instead, at the last minute, Congress passed and the President signed the Budget Control Act.

IV. DEBT CEILING RESOLUTION—THE "SUPER COMMITTEE"

A. The Budget Control Act

The Budget Control Act permitted an increase in the debt ceiling (at least until late 2012 or early 2013), but it also effectively delegated a solution to the U.S. fiscal problem to a "super committee" made up of six Democrats and Six Republicans. The super committee was given until November 23, 2011, to come up with a comprehensive plan to reduce the U.S. federal government deficit by $1.5 trillion over 10 years. If the committee failed to produce a recommendation that garnered a majority of the committee (meaning that one member would have to "switch sides," given the even 6-6 split), then automatic spending cuts (called "sequestration") of $1.2 trillion would begin in 2013, fairly evenly split between defense spending and other types of federal spending.[22] Specifically, $492 billion would be cut from each of the defense budget and the non-defense budgets (for a total of $984 billion), and $216 billion would be saved due to reduced interest payments on the consequently lower federal debt.[23]

B. Results of Super Committee

Not surprisingly, after three months of negotiations, the super committee failed to resolve the tax legislation problem and instead "kicked the can down the road," so to speak.[24] The super committee had the rare opportunity to resolve fiscal problems by quickly moving legislation through a gridlocked Congress.[25] Democrats blamed the Republicans and Republicans blamed the Democrats for the failure, though.[26] The co-chairs of the bipartisan super committee issued a statement that "after months of hard work and intense deliberations, we have come to the conclusion today that it will not be possible to make any bipartisan agreement available to the public before the committee's deadline."[27] The super committee's failure led to, among other things, increased investor uncertainty as evidenced by the subsequent downgrading of the United States' credit rating.

If no further action is taken, the automatic spending cuts described above will commence in early 2013.[28] Both sides agree that the arbitrary cuts—commencing with $110 billion on January 2, 2013—should be replaced with a more thoughtful budget agreement, but they are diabolically divided on where to make the cuts and whether to increase taxes.[29]

V. 2011-2012 – NEW PROPOSALS

As noted above, the super committee failed in its quest to agree on a comprehensive tax and budget reform solution. However, during the super committee process, each party put forth new and fairly detailed proposals that are worthy of further detailed analysis.

A. Republican Proposals

On the Republican side, two important proposals were announced. First, in late October, 2011, House Ways & Means Chairman Dave Camp released the first part of what he called a "comprehensive" tax reform proposal. This first

part is the first serious proposal to change the U.S. system of taxing international corporate income to a "territorial" system, away from the current "hybrid worldwide" approach. Then, in early 2012, Representative Paul Ryan (Chair of the House Budget Committee) put out a comprehensive budget proposal. Each is now discussed in turn.

1. Representative Camp's "Territoriality"

As noted, Representative Camp's proposal is meant to encompass comprehensive tax reform, including individual, corporate, and international reform.[30] So far, only the international portion of this plan has been released; however, Rep. Camp's plan does say that he would reduce the overall corporate tax rate to 25 percent (from its current 35 percent level), and that this rate reduction would be accomplished in a revenue-neutral way by broadening the corporate tax base. The individual portions of his plan are presumably similar to those put forth by Rep. Ryan (discussed below). The international provisions of his plan are summarized immediately below.

By way of background, currently U.S. corporations are taxed on their worldwide income, no matter where earned. U.S. corporations have an opportunity to "defer" U.S. taxation of foreign earnings, provided such amounts are earned by a foreign subsidiary in a manner that avoids U.S. "anti-deferral" rules (known as "Subpart F"), and such amounts are not repatriated to the U.S. This system has been criticized as creating an incentive for the retention of earnings offshore (the so-called "lockout" effect). Also, the worldwide system, when combined with a 35-percent corporate tax rate, has been criticized as putting U.S. multinationals at a competitive disadvantage.

Rep. Camp's plan would abandon the worldwide system and move the U.S. to a "territorial" system, whereby the foreign earnings of U.S. multinationals would be mostly exempt from U.S. taxation, whether such earnings were repatriated or not. Specifically, U.S. corporations would be entitled to a 95 percent dividends received deduction (DRD) for dividends received from Controlled Foreign Corporations (CFCs) in which the U.S. corporation held a 10 percent or greater interest. Likewise, the sale of CFC stock, in most cases, would be exempt from U.S. taxation. Foreign "branches" of the U.S. corporation would be treated as CFCs for this purpose.

The proposal would retain and actually strengthen the current Subpart F regime, under which certain types of income earned by a CFC is taxed, as earned, to its U.S. parent as if such income were earned directly by the U.S. parent. Subpart F would be strengthened by adding one of three possible "options" to current law, in order to deal with the increased incentive, under an exemption system, for U.S. MNCs to shift assets and income offshore. One of the options is to tax currently in the U.S. any "excess intangibles income" earned by a CFC, which is the same as the Obama Administration's proposal (discussed below). The second option would treat a CFC's income as being all Subpart F (and hence subject to U.S. tax), if the CFC's effective foreign tax rate is below a certain percentage. The final option would treat all of a CFC's income from intangible assets as being Subpart F, but only 60 percent of such amount would be subject to U.S. taxation. This last proposal would also allow the U.S. parent a deduction equal to 40 percent of its foreign intangibles income, and thus operates somewhat in the form of a "patent box" that many other nations are now adopting.

2. Ryan Proposals

Rep. Ryan's proposals were released in February 2012 in a document called "Path to Prosperity."[31] This proposal is a comprehensive solution to the budget and deficit program in the U.S., and hence it includes spending and taxation proposals. The taxation proposals will be discussed first, but given their importance, some mention will be made here of the overall spending framework proposed by Rep. Ryan.

On the taxation side, Ryan agrees (not surprisingly) that the international system should be moved to a territorial system, presumably the one that Rep. Camp is proposing. He also agrees that the corporate tax rate should be reduced to 25 percent. Where Ryan's proposal adds some specificity is on the individual tax side—his proposal would reduce the individual tax system to reflect just two brackets, one at 10 percent and one at 25 percent. Also, the alternative minimum tax (AMT) would be eliminated.

Interestingly, the proposal does not propose specifics with respect to capital gains and dividend tax rates. Also, the proposal offers very little in specifics as to which tax "subsidies" or expenditures would be eliminated in order to "broaden the base" to permit Ryan's system to collect at least 18 percent of GDP in revenue at such low tax rates, as he states is his goal. Rep. Ryan does make reference to a potential change in (or elimination of) the current exclusion from gross income for employer-provided health insurance, to be made as part of an overall change to the U.S. healthcare system. Supporters of Rep. Ryan's plan have indicated that there will be (unspecified) base broadening,[32] but tax policy purists cannot have been encouraged by Rep. Camp's recent statement this his plan (and presumably Rep. Ryan's) will not change the current mortgage interest deduction.[33] If the mortgage interest deduction is not "on the table," then one may wonder exactly which "subsidies" will be eliminated to pay for the reduction in tax rates.

Lastly, a brief word about Rep. Ryan's spending priorities. His budget would "cap" U.S. government spending at a particular percentage of GDP, which in his case would be 18 percent. However, while capping overall federal spending, Rep. Ryan's plan would actually increase defense spending over the next decade. To pay for this, and stay below 18 percent of GDP in spending, would require significant cuts in other areas of spending, including Medicare, which Rep. Ryan would (somewhat notoriously) put into competition with private insurers. Medicaid would be converted to a block grant to states, and other popular programs (such as the National Endowment for the Arts) would face possible elimination.

B. Administration Budget and Framework

Likewise, the Democrats have put forth a variety of proposals to reform the tax system and reduce the deficit. Many of these proposals were included in the President's 2013 Budget proposals, issued in February 2012. In addition to the Budget, the President also issued a business tax "framework" paper in late February 2012. Both are discussed below.

1. 2013 Budget Proposals[34]

The most prominent provision included in the President's budget is the proposal to increase tax rates on high earners, back to the rates in place prior to the 2001 and 2003 tax rate reductions.[35] President Obama maintains that raising taxes on the wealthy is "about the nation's welfare."[36] Likewise, the capital gains tax rate would increase to 20 percent (from its current 15 percent) for these high earners, and their dividends would also be subject to taxation at ordinary income rates (which would become 39.6 percent[37] for those in the top bracket). Further, the estate and gift tax parameters in effect in 2009 would be restored. Also, the proposal contains a number of other, smaller provisions, including a proposal to extend 100 percent bonus depreciation for another year.

On the international side, the President's Budget included a number of provisions that have been previously proposed. Most of these proposals merely tighten up the existing hybrid worldwide international tax system. The most important of these is the proposal to impose current U.S. taxation on the "excess intangibles income" earned by foreign subsidiaries of U.S. corporations. These proposals reflect an important difference between the two parties—as noted above, the Republicans want to move towards a territorial system, while the Democrats would maintain (and strengthen) the existing international tax regime.

2. The Business Tax "Framework"

The Administration's "Framework" gave further details on its views on business taxation.[38] Most importantly, the Framework states that the corporate tax rate should be reduced to 28 percent, in return for base-broadening to make up for the lost revenue. The base-broadening would include elimination of LIFO, elimination of oil & gas "tax preferences," taxing "carried interest" as ordinary income, and elimination of bonus or even accelerated depreciation.[39]

Further, the Framework would consider taxing large passthrough entities as though they were corporations.[40] Also, manufacturing income would be taxed at just a 25 percent rate, and the R&E credit would be made permanent. Lastly, there is some indication that the Framework would consider imposing some limits on the ability of corporations to deduct interest payments.

On the international side, the Framework would maintain the current worldwide hybrid international system, and would even strengthen it, in the name of preserving jobs and manufacturing activity within the U.S. The Framework's major international contribution (in addition to the Budget proposals noted above) is to propose imposition of a "minimum tax" on the overseas profits of U.S. MNCs. Presumably, this would look something like the system in Japan, where the earnings of a CFC are taxed currently in the home country if the CFC's effective foreign tax rate is below a certain number (say 10 or 20 percent).

VI. 2012 LEGISLATIVE ACCOMPLISHMENTS (OR LACK THEREOF)

After the failure of the super committee, and with a presidential election on the horizon, hopes were not high for legislative accomplishments during 2012. After one of the most contentious fiscal policy battles of the 112th Congress, on February 10, 2012, Congress extended the payroll tax cuts and unemployment benefits which were set to expire from the 2010 Tax Relief Act.[41] The bill kept, among other things, a two percentage-point payroll tax cut for 160 million wage-earners through the end of 2012, provided additional unemployment benefits, and protected doctors who receive Medicare payments from a cut in reimbursements.[42] Both Republicans and Democrats claimed it as a "win," although the Democrats likely carried the day as Republicans gave up on having the tax cuts be paid for and the cuts will simply further increase the deficit.[43] According to the Congressional Budget Office, the bill increased the deficit by $126 billion over the next five years.[44] Speaker of the House John Boehner (Republican from Ohio), supported the bill but added, "[L]et's be honest, this is an economic relief package, not a bill that's going to grow the economy and create jobs;" moreover, many of the provisions in this

bill, and the other bills passed during President Obama's tenure, are set to expire at the end of 2012.[45] Thus, the members of the 112th Congress still have a lot of work to do and the upcoming elections are paramount.

VII. CONCLUSION—A MURKY FUTURE

As can be readily seen from the above summary of proposals, and the lack of progress in 2012, Democrats and Republicans remain far apart on a variety of tax policy positions. In particular, Republicans oppose the Administration's ideas on taxing large pass-throughs as corporations, and taxing carried interests as ordinary income. But probably the biggest area of difference is in the international arena—Republicans are now committed to a move to a territorial international tax system, whereas the Administration is committed to maintaining and strengthening the current hybrid worldwide system.

However, there are some broad areas of agreement. Both parties agree on the need for a lower corporate tax rate, for example. Also, interestingly, both agree (at least in principle) on the need for stronger rules to tax the international IP-related income of U.S. MNCs.

Where all agree is that there will be no further action of any significance prior to the 2012 elections.[46] After the 2012 elections, there is likely to be a "mad scramble" to implement some sort of compromise to prevent an automatic increase in the income and payroll tax rates, and automatic spending cuts, all of which will take place unless there is further Congressional action.[47] Also, various other expiring provisions (called "extenders"), including the AMT "patch," will require attention before year end.

Hence, early 2013, before Congressional attention turns to the 2014 mid-term election, may be the best time for comprehensive tax reform. At least some members of Congress see the need for comprehensive change,[48] and the framework that was temporarily agreed in the summer of 2011, plus the Obama and Camp proposals described above, give some idea as to the form that the ultimate compromise will take. The question will be this: what mix of revenue increases (if any) and spending cuts will eventually be agreed to in order that the deficit (and resulting growth in U.S. federal debt) finally begins to moderate.

ENDNOTES

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33. Rothman & White, *Camp Not Looking at Mortgage Interest Deduction as Romney Backs Off Comments*, Bureau of National Affairs (BNA) Tax Daily, April 17, 2012.

34. The Administration's Budget is available on the White House website here: http://www.whitehouse.gov/omb/budget.

35. John D. McKinnon, *Top 1% Would See $90,000 Tax Rise, Report Says*, Wall Street Journal, March 23, 2012 (President Obama proposes $1.4 trillion in tax increases over 10 years for "higher earners" (couples making more than $250,000)).

36. *Id.*

37. The tax rate on dividends would actually be higher than 39.6% if the imposition of a Medicare tax on certain levels of passive income, which was enacted as part of Mr. Obama's 2010 health care overhaul, takes effect as scheduled in 2013.

38. The Framework is available online here: http://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-02-22-2012.pdf/

39. On this last issue, the Framework is inconsistent (at least temporarily) with the President's own budget, which has proposed extension of 100 percent bonus depreciation through 2013.

40. There is some indication that "large" passthroughs in this context mean those with gross receipts in excess of $25 million.

41. *See* Robert Pear and Jennifer Steinhauer, *Tax Cut Extension Passes; Everyone Claims a Win*, The New York Times, February 17, 2012 (It was the second bill in the 112th Congress to be split by party lines; the other being a spending bill.).

42. *Id.*; *see also* Annie Lowrey, *Tax-Cut Bill Includes Updates to Jobless Benefits System*, The New York Times, February 21, 2012.

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44. *Id.*

45. Jason Linkins, *John Boehner Upset That the Payroll Tax Cut Extension Means Ordinary Americans Will Have More Money*, The Huffington Post, Politics, February 17, 2012.

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47. This prediction has been made by many, including George Callas, Staff Director, Subcommittee on Select Revenue Measures, House Committee on Ways and Means, in a conference call that he held with the State Bar of California Taxation Section on April 19, 2012.

48. Bai, *supra* note 21, at 47 (citing a statement by Speaker Boehner that the U.S. is "heading toward a very bit moment, where big decisions are going to have to be made about the future of our country").

What You Do Not Know About IRAs Could Cost Your Clients Money

By Bernard J. Gartland[1]

I. INTRODUCTION

As recently as March 2010, it was estimated that there are over $4.3 trillion invested in Individual Retirement Accounts (IRAs),[2] another $12 trillion if you look at the entire retirement plan market.[3] These numbers reflect the fact that over 40 percent of US households have an IRA.

Even though these investment accounts permeate our financial lives, few professional advisors, much less the individual owners themselves, really know the rules governing individual retirement accounts.

The challenge is that due to the complications of the tax code, everyday occurrences can cause an IRA to be completely and fully distributed for tax purposes. Additionally, if the IRA is considered distributed for tax reporting purposes, it has probably lost any asset protection as an asset exempt from the claims of creditors as well.

II. PROHIBITED TRANSACTIONS AND IRAS

As a general rule, IRAs are accounts that are exempt from taxes on their earnings.[4] The beneficiaries are only taxed when they start taking distributions from the IRA.[5]

If the IRA engages in a prohibited transaction as per Internal Revenue Code section 4975(c), the IRA ceases to be an IRA as of the first day of the taxable year the prohibited transaction occurred. Furthermore, the account is treated as if it made a distribution at fair market value of all its assets as of the first day of the taxable year. [6]

Example: Joe has a $100,000 IRA on January 1, 2009. On October 31, Joe engages in a prohibited transaction with his IRA, now valued at $75,000. Since the account is no longer an IRA, Joe has not only lost all future tax deferral **BUT** he now owes taxes on $100,000 of income, as that was the value of the account on January 1.

Amongst other things, a prohibited transaction is defined under IRC section 4975(c)(1)(b) (emphasis added) as the "*lending of money or other extension of credit* between a plan and a disqualified person." *The IRA owner is considered a disqualified person to the IRA.*

III. BROKERAGE AGREEMENTS CREATE PROHIBITED TRANSACTIONS

In general, a requirement for opening an IRA with a brokerage firm is to agree to the brokerage firm's standardized "brokerage agreement."

A typical term in the brokerage agreement is a requirement for the client to personally guarantee the account and or grant the brokerage firm a lien on all other assets, including personal accounts, the client may have at the firm.

A recent ruling from the Department of Labor (DOL)[7] addresses the question of whether such language would be considered an extension of credit and thus a prohibited transaction. In October of 2009, the DOL released Opinion 2009-3A. In its Opinion, the DOL stated,

> Here, the requested granting of a security interest in the assets of the IRA owner's personal accounts to the Broker to cover the IRA's debts to the Broker is akin to a guarantee of such debts by the IRA owner. This would amount to an extension of credit from the IRA owner to the IRA.

Don't think a brokerage firm would require such a guarantee? Read some of the following and come to your own conclusions:

> **9. Security Interest.** As security for the repayment of my present or future indebtedness under the Account Agreement or otherwise, I grant to XXXX Investments a first, perfected and prior lien, a continuing security interest, and right of set-off with respect to all securities and other property that are, now or in the future, held, carried, or maintained for any purpose in or through my Brokerage Account or Settlement Choice and any present or future accounts maintained by or through you or your affiliates;
>
> ***--Brokerage Firm A***

> **Section 7: Granting a Lien on Your Accounts.** As security for the repayment of all present or future indebtedness owed to us by each Account Holder, each Account Holder grants to us a first, perfected and prior lien, a continuing security interest, and right of set-off with respect to, all property that is, now or in the future, held, carried or maintained for any purpose in or through XXXX, and, to the extent of such Account Holder's interest in or through,
>
> ***--Brokerage Firm B***

IV. RAMIFICATIONS

Based upon the ruling by the DOL, it appears there are millions of zombie IRAs. While the average citizen and professional advisor are acting on the belief the IRA is "qualified," there is a very high likelihood the IRAs are not qualified and are instead mounting up very large tax bills.

Even more troublesome is the fact that transactions that would normally be commonplace with "qualified" IRAs do nothing but add more to the unknown tax bill.

Consider rollovers and transfers of IRAs. In order to roll over or transfer from one IRA to another, you obviously need a "qualified" IRA as the starting point. If the account is no longer an IRA, that means nonqualified funds are being transferred into a qualified fund. Under the tax code, these "excess" contributions are subject to a 6 percent excise tax each year they remain in the plan.[8]

Example: Steve had an IRA worth $100,000. In 2005, he opened an account for his IRA at a brokerage firm that required him to personally guarantee the account. His account would be considered fully distributed as of January 1, 2005. In 2007, Steve rolled what he thought was an IRA into an IRA with a new brokerage firm. If the account was still valued at $100,000, Steve is now liable for an excise tax of $6,000 a year in addition to any other taxes that came due when he engaged in the inadvertent prohibited transaction.

Right now, the hot financial planning topic is to convert a traditional IRA over to a Roth IRA. What happens to individuals who don't have traditional IRAs anymore? Are they allowed to convert what is now merely a personal investment account into a Roth? No. Instead of building up tax-free income, they are building up 6 percent annual excise tax fees.

Another concern is the bankruptcy protection given to IRAs. In most jurisdictions IRAs are considered exempt assets, not subject to the claims of their creditors.

If in fact the IRA has engaged in a prohibited transaction, the IRA is no longer an IRA and thus no longer an exempt asset. There are a number of bankruptcy trustees who are now reviewing debtor's IRAs to see if they have run afoul of the prohibited transaction rules.

ENDNOTES

1. Bernard J. Gartland is with The Gartland Group of Palm Desert, California. He may be reached at (760) 345-1500 or Bernie@gartlandgroup.com.

2. "Retirement Snapshot, First Quarter 2010," Investment Company Institute.

3. Ibid.

4. I.R.C. § 408(a).

5. I.R.C. § 408(d).

6. I.R.C. § 408 (e)(2).

7. Under Reorganization Plan No. 4 of 1978, effective December 31, 1978, the authority of the Secretary of the Treasury to issue interpretations regarding Section 4975 of the Internal Revenue Code was transferred to the Secretary of Labor. The Secretary of the Treasury is bound by the interpretation of the Secretary of Labor pursuant to such authority.

8. I.R.C. § 4973.

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BAR BUSINESS

Taxation Section Overview

MEMBERSHIP

Membership is open to everyone including lawyers, accountants, enrolled agents, trust officers, etc. The Section maintains two levels of membership: Regular membership for those who are admitted to the State Bar of California, and Associate membership for all others, such as lawyers admitted in other states. Joining the Section may be done through the Section's website, or by contacting **Lynn Taylor**, Taxation Section Coordinator at the State Bar, at (415) 538-2580 or lynn.taylor@calbar.ca.gov.

LEADERSHIP

The Taxation Section is led by an Executive Committee comprised of three officers and fifteen members. It is supported by the chairs of the Standing Committees; in addition, a select number of government representatives and leading tax practitioners serve as advisors. Please see the Taxation Section Leadership Directory, *infra*, for a listing of the individuals involved. The Executive Committee typically meets four times a year to attend to Section business. Applications for appointment in September are typically due the preceding January. For more information, contact **Fred Campbell-Craven**, Chair of the Section, at (530) 845-3796 or fred.campbell-craven@ftb.ca.gov.

STANDING COMMITTEES

The Taxation Section sponsors a number of Standing Committees focusing on various areas of substantive tax law, tax practice, and tax policy. The Standing Committees actively support and participate in the activities of the Section by, among other things, preparing papers for the annual Washington, D.C. Delegation, developing and presenting panels at the Annual Meeting of the California Tax Bar and California Tax Policy Conference, and soliciting, drafting, or reviewing articles for the *California Tax Lawyer*. In addition, many committees host their own meetings, conferences, or events throughout the year. Major events sponsored by the Standing Committees include the Annual Estate & Gift Tax Conference and the Annual Income & Other Taxes Seminar. The ten standing committees are:

- Compensation and Benefits;
- Corporate and Pass-Through Entities;
- Estate and Gift Tax;
- Income and Other Taxes;
- International Tax;
- State and Local Tax;
- Tax Exempt Organizations;
- Tax Policy, Practice and Legislation;
- Tax Procedure and Litigation; and
- Young Tax Lawyers.

For more information on a Standing Committee, please contact one of the committee officers listed under the Taxation Section Leadership Directory, *infra*. In addition, throughout the year the various Standing Committees will be highlighted in the Visiting the Committees section. Joining a committee can be done either by contacting one of the committee's officers, through the Section's website, or by contacting **Lynn Taylor**, Taxation Section Coordinator at the State Bar, at (415) 538-2580 or lynn.taylor@calbar.ca.gov. Involvement in a Standing Committee provides practitioners opportunities to enhance their knowledge, build eminence, and expand their networks.

PUBLICATIONS

The *California Tax Lawyer* is the official publication of the Taxation Section. Published four times a year, the *California Tax Lawyer* includes a variety of content, including expositive articles on federal and state tax matters (which do not generally have any page limitation, but which often run between 4,000 and 10,000 words, or approximately four to seven pages before endnotes), shorter substantive or technical updates (suggested length of around 750-1,500 words, or approximately one to two pages when published), as well as periodic compilations on selected federal and state matters. Each issue also contains a Bar Business section which contains information about the Section, the Standing Committees, and their activities. Included in the Visiting the Committees column is a "Some Quick Points" piece which provides brief (generally under 400 words) observations or commentaries on recent developments

and practice-related matters submitted by members of the Standing Committees. In addition, the Bar Business section periodically presents other items of interest to the California tax community, such as reports on the annual Washington, D.C. delegation and the Annual Meeting of the California Tax Bar and California Tax Policy Conference, and minutes of Eagle Lodge West. Submissions are typically due February 15, May 15, August 15, and November 15. Publication guidelines are posted on the Section's web site. For more information, contact **Michael Fang**, Editor-in-Chief, at (415) 894-8851 or michael.fang@ey.com.

ANNUAL WASHINGTON, D.C. DELEGATION

Each spring the California State Bar Taxation Section, together with the Los Angeles County Bar Association, sends a delegation to Washington, D.C. to present original papers regarding legislative, regulatory, or administrative proposals to key tax officials in the Treasury, the IRS, and the Tax Court, as well as to the staffs of the House Ways and Means Committee and the Senate Finance Committee. Planning for each year's conference begins the preceding August, when the standing committees begin generating paper topics. For more information regarding the 2013 Delegation, contact **Geoffrey Weg** of the Executive Committee at (310) 277-8011 or gaw@vrmlaw.com.

ANNUAL MEETING OF THE CALIFORNIA TAX BAR AND CALIFORNIA TAX POLICY CONFERENCE

Each November, the Section hosts a multiple-day conference to address current issues in tax planning, controversy, policy, and practice. The conference has two distinct threads. The Annual Meeting focuses on a wide variety of federal topics, while the California Tax Policy Conference focuses on the application of California tax law. Approximately 40 programs are presented each year, which are led by prominent tax practitioners and representatives from government, including Treasury, IRS, Tax Court, the FTB, and the BOE. Planning for each year's conference begins the preceding February and March, when the standing committees generate program proposals. For more information about the 2012 Annual Meeting, contact **Annette Nellen** of the Executive Committee at (408) 924-3508 or annette.nellen@sjsu.edu. For more information about the 2012 California Tax Policy Conference, contact **Carley Roberts**, Immediate Past Chair of the Section, at (916) 792-7192 or carley.roberts@sutherland.com.

EAGLE LODGE WEST

Held in late April or early May each year, Eagle Lodge West is an annual invitational event where selected practitioners meet with representatives of the Board of Equalization, Franchise Tax Board, and/or Employment Development Department to collaboratively seek to address, and find potential solutions for specifically identified issues. Planning for each year's event starts the December before. For more information, contact either **Brad Marsh,** Chair Elect of the Section, at (415) 591-1000 or bmarsh@winston.com, or **Valerie Dickerson** of the Executive Committee at (714) 436-7657 or vdickerson@deloitte.com.

STATE BAR FUNCTIONS

The Section sponsors programs at the State Bar Annual Meeting (held in September) and the Section Education Institute (SEI; held in January). Planning for the Annual Meeting begins approximately eight months before, and planning for SEI begins approximately five months before, when the standing committees generate program proposals. For more information, contact **Steven Walker** of the Executive Committee at (408) 828-9989 or swalker@walklaw.com.

WEBSITE

The Section's website may be found at **http://taxation.calbar.ca.gov/**. The website has both a public area and Members Only Area. Among other things, the public area provides information on upcoming events as well as links to a variety of useful governmental and other websites. The Members Only Area includes the selected articles from past issues of the *California Tax Lawyer*. To access the Members Only Area, users will need to login using their member (bar) number and password (self selected). For more information, contact **Michael Fang** of the Executive Committee at (415) 894-8851 or michael.fang@ey.com.

IN THIS ISSUE

2012 Annual Washington, DC, Delegation - May 6-8, 2012

By Julie Treppa[1]

Members of the 2012 Washington Delegation, comprised of 30 members in total from the Taxation Sections of the State Bar of California ("State Bar") and Los Angeles County Bar Association ("LACBA") (together, the "Tax Sections"), have returned to California after another very successful annual trip to Washington, D. C. (the "Delegation"). The Delegation took place from Sunday, May 6, 2012 through Tuesday, May 8, 2012.

This article briefly: (1) summarizes the background and purpose of the Delegation; (2) lists the fifteen papers presented during this year's Delegation; (3) identifies the schedule of events and governmental offices visited during the Delegation, (4) thanks those individuals from the Tax Sections who made this Delegation possible; and (5) provides information on how to get involved with next year's 2013 Washington Delegation.

I. HISTORY AND PURPOSE OF THE WASHINGTON DELEGATION TRIP

Since 1989, the Tax Sections, working together, have sent an annual delegation to Washington D.C. to present papers on issues of concern to California Tax practitioners. Historically, and most recently, during the beginning of May, the Delegation meets with a number of United States Tax Court judges and key governmental officials from the Internal Revenue Service Office of Chief Counsel, the Taxpayer Advocate's Office, the Treasury Department, the House Ways and Means Committee's tax staff, the Senate Finance Committee's tax staff, and the Joint Committee on Taxation's tax staff.

The Delegation serves a variety of functions. The most important function is to make a substantive contribution to the tax laws. A number of proposals made during past Delegations, substantively and procedurally, have been adopted in one form or another in the tax law or regulations.

The Delegation also familiarizes government officials with the existence, experience, and concerns of California tax lawyers. Past Delegations have increased the awareness of government tax officials and have enhanced the Tax Sections' ability to play a part in tax policy. Through the Delegation, the Tax Sections strive to encourage tax officials in Washington D.C. to consider the California Bar (i.e., the Tax Sections) as an available resource.

The Delegation also benefits the individual Delegation members. The Delegation provides an extremely valuable insight into how the government functions and the issues that concern those who formulate the tax laws and regulations. It also provides the respective Delegation members an opportunity to develop relationships with government staffers who work in their areas of practice.

Lastly, after the trip, papers are typically published by both national and state-wide tax journals such as the *California Tax Lawyer* and *Tax Notes Today*.

II. 2012 WASHINGTON DELEGATION PAPERS AND PRESENTERS

Last year, beginning in September 2011, the Tax Sections began their task of finding paper topics and presenters. This work resulted in the following fifteen papers being presented during the 2012 Washington Delegation:

1. *Proposed Guidance: Why Mexican Retirement Funds Should Not Be Subject to the New Reporting Requirements under IRC Section 1298(f)*, Pedro E. Corona and Enrique Hernandez (International);

2 *Proposed Guidance Under Treasury Regulations Section 1.954-2(d)(1)(i)*, Jenna Shih and Steven Po Han Chen (International);

3. *Proposed Expansion of Category of Registered Deemed-Compliant FFI: "The Good Faith Local FFI" and the Accidental American*, Patrick W. Martin and Liliana Menzie (International);

4. *Proposed Changes to Treasury Regulation Section 1.45D-1 to Encourage New Markets Tax Credit Investments in Non Real Estate Businesses in Low-Income Communities*, Charles Taylor (Tax Policy, Practice and Legislation);

5. *FAQs: Problems With the Process of Informal Guidance From the Internal Revenue Service*,

Robert S. Horwitz and Annette Nellen (Tax Policy, Practice and Legislation);

6. *Proposed Guidance Under Code Section 2501*, Mary K. deLeo and Claire F. Hofbauer (Estate and Gift);

7. *Estate and Gift Tax Discussion Points*, Robin L. Klomparens and Dennis I. Leonard (Estate and Gift);

8. *Proposed Guidance for the Definition of Assets under Section 108(d)(3)*, Haleh Naimi (Corporate and Pass-Through);

9. *Lack of Collection Due Process Rights for Co-Owners of Property: a California Community Property Perspective*, Patrick Crawford (Tax Procedure and Litigation);

10. *Proposed Revisions to Administrative Procedure for Collection Due Process Hearings Pursuant to IRC Section 6330*, Joseph P. Wilson and Elizabeth Van Clief (Tax Procedure and Litigation);

11. *A Simplified Procedure to Allow Late Filed Forms 8891 for Individuals With Canadian Retirement Plans and Relief From FBAR Penalties for Foreign Retirement Accounts*, Philip D.W. Hodgen and Steven L. Walker (Tax Procedure and Litigation);

12. *Proposed Amendments to Internal Revenue Code Section 1031*, Ciro Immordino (Income and Other);

13. *Balancing Privacy and Efficiency Under Section 7602: What Is "Reasonable Notice" and Changing IRS Procedures Related to Third-Party Contacts*, Kevan P. McLaughlin (Young Tax Lawyers);

14. *Determining "Material Participation" by a Trust Under the New Medicare Contribution Tax*, Douglas W. Schwartz (LA County Bar Association); and

15. *Taxation Without Borders: Allowing States to Collect Tax From Out-of-State Sellers*, Gregory A. Zbylut (LA County Bar Association).

III. SCHEDULE OF EVENTS DURING THE 2012 WASHINGTON DELEGATION

The following is a short summary of the Delegation's itinerary this year:

- **Sunday, May 6, 2012.** The Planning Committee of the Delegation met Sunday afternoon to finalize certain aspects of the presentations that were to begin on Monday. Later Sunday evening, the entire Delegation (including some guests) met for a "rehearsal dinner" at Morton's Steakhouse, where each of the presenters provided a brief summary of his or her respective paper to the entire Delegation.

- **Monday, May 7, 2012.** Monday morning the Delegation went to the IRS Office of Chief Counsel. Papers selected by various attorneys at the IRS Office of Chief Counsel were presented to attorneys who practice in the subject area of the particular paper topic. Certain papers were also heard by Nina Olson, the National Taxpayer Advocate, along with her staff. In addition, members of the Delegation met with Karen Hawkins, Director of the Office of Professional Responsibility, and her staff.

  Afterwards, members of the Delegation had lunch at the famous Old Ebbitt Grill.

  Monday afternoon the Delegation met with the Treasury Department, where the papers and presenters were divided into groups, with the presentations being made to Treasury staff members with specialized knowledge of the particular topic(s) being presented.

  The day was capped off with a cocktail reception at the historic Dolley Madison House (a short walk from the White House) hosted by the Delegation. A number of the key governmental officials and judges attended, including several of the Tax Court judges.

- **Tuesday, May 8, 2012.** Paper presenters met with the Joint Committee on Taxation from 10:00 a.m. to 12:00 p.m. to present their papers. Other Delegates went to the Tax Court, where they met with certain Tax Court judges at the very table at which those judges discuss the Tax Court cases they hear. This session was also attended by certain upper level management

members of the Office of Chief Counsel. In accordance with the prior request of the Tax Court judges, no papers were presented. Rather, in accordance with the Tax Court judges' request, a roundtable discussion was held with respect to practitioners' comments and issues having to do with the processing of cases. Members of the Tax Court and of Chief Counsel's Office participated in this process, all of which was designed to find ways to improve the experience of all concerned. In addition, at the request of the Tax Court, a presentation was given regarding the status of *pro se* programs throughout California. After the conference, the Delegation (including those who had been at the Joint Committee on Taxation) had lunch with the Tax Court judges and members of Chief Counsel's Office in the Tax Court judges' private dining room.

Tuesday afternoon, members of the Delegation headed back up to "the Hill," where they met with the Senate Finance Committee tax staff and the tax staff from the House Ways and Means Committee to present those papers that had been specified by the staffers.

IV. THANK YOU TO MEMBERS OF THE 2012 WASHINGTON DELEGATION

The success of the 2012 Washington Delegation was due, in large part, to the outstanding contributions of the authors and presenters of the papers. Also essential to the success of this year's Delegation were the efforts of the committee chairs of the respective Taxation Sections, and the 2012 Washington Delegation Planning Committees of both the LACBA and the State Bar. The 2012 Washington Delegation Planning Committee includes, in no particular order, Stephen Turanchik (Member, LACBA Executive Committee, Co-Chair of the 2012 Washington Delegation Planning Committee), Felicia Chang (Chair, LACBA Tax Section), John Harbin (Chair-Elect, LACBA Tax Section), Douglas Youmans (Chair, State Bar Taxation Section Executive Committee), Fred Campbell-Craven (Chair-Elect, State Bar Taxation Section Executive Committee), Geoffrey Weg (Member, State Bar Taxation Section Executive Committee), Andrea Kushner Ross (Member, State Bar Taxation Section Executive Committee), Robert Horwitz (Member, State Bar Taxation Section Executive Committee), David Roth (Member, State Bar Taxation Section Executive Committee), and Julie Treppa (Member, State Bar Taxation Section Executive Committee, Co-Chair of the 2012 Washington Delegation Planning Committee). A special thank you goes to Marcy Jo Mandel, Deputy State Controller, Office of State Controller John Chiang, for her continued support, participation, and guidance as a member of the Delegation. The author also wishes to personally thank David Roth, Co-Chair of the 2011 Delegation, for his counsel and suggestions which helped to make the 2012 Delegation a success.

V. NEXT YEAR'S 2013 WASHINGTON DELEGATION

Next year's Delegation is tentatively planned for May 5-7, 2013. If you are interested in drafting and presenting a paper, or you have any suggested paper topics, please contact Julie Treppa at Coblentz, Patch, Duffy & Bass LLP, One Ferry Building, Suite 200, San Francisco, CA 94111; Telephone: 415-772-5765 or at JAT@cpdb.com.

ENDNOTES

1. Julie Treppa is a member of the Executive Committee of the Taxation Section of the California State Bar.

Minutes from the 2012 Meeting of Eagle Lodge West - April 27-28, 2012

By Valerie C. Dickerson, Lorin Engquist, and Troy Van Dongen

I. INTRODUCTION

On April 27 and 28, 2012, the Taxation Section of the State Bar of California, including the State and Local Tax Committee of the Taxation Section, sponsored the 2012 Eagle Lodge West Conference at the Vintner's Inn located in Sonoma County. Eagle Lodge West is an annual assembly of government and private tax practitioners brought together for the purpose of discussing current topics in California taxation and suggesting reforms. In 2012, there were two committees at Eagle Lodge West, namely, the Property and Sales Tax Committee and the Franchise and Income Tax Committee. The Property and Sales Tax Committee included Bradley Heller, Richard Kinyon, Bradley Marsh, Brad Miller, Richard Moon, Jeffrey Olson, Carole Ruwart, Troy Van Dongen, and Robert Waldow. The Franchise and Income Tax Committee included Fred Campbell-Craven, Lorin Engquist, David Gemmingen, Shane Hofeling, Carl Joseph, Patrick Kusiak, Geoff Way, and Barry Weissman. The following represents the minutes of the committees:

II. PROPERTY AND SALES TAX COMMITTEE

A. Property Tax—Amending Claims for the Parent-Child Exclusion from Reassessment

The first topic for discussion addressed whether the State Board of Equalization ("SBE") should issue guidance on whether claims for exclusion from reassessment on transfers of real property between parents and their children or grandparents and their grandchildren may be amended.

Background: Under California law, the reassessment of real property is not required on a transfer of a principal residence when the transfer is between parents and their children. In addition, aggregate transfers of up to $1 million of full cash value of other real property between parents and their children (or qualified grandchildren) are excluded from reassessment.

The transferee, or his or her legal representative, is required to file a claim for the exclusion on a form prescribed by the SBE. A form is timely if filed within three years after the date of the transfer, or prior to transfer of the property to a third party, whichever is earlier. In addition, a claim is considered timely if it is filed within six months after the mailing of a notice of supplemental or escape assessment issued as a result of the transfer. If the property has not been transferred to a third party, a claim may be filed after expiration of the aforementioned periods, but the exclusion will not apply until the assessment year in which the claim is filed, and prospectively thereafter.

Discussion: The participants explained that administration of a typical estate or administrative trust can take several years or more. For example, an administrator or successor trustee may need to be identified, and that representative may need over a year to identify all the assets contained within the estate or trust, the claims for which the estate or trust is responsible, and other matters of administration. In addition, identification of the specific assets (including real properties) that will be distributed to each beneficiary also can take months. Yet, the local assessors often want, or need, to quickly identify properties within their jurisdiction that may be subject to reassessment. Complicating matters further, the current claim form is somewhat ambiguous when multiple transferees (or potential transferees) must be identified.

Although the statutes and regulations explain that a claim form must be filed in order to avoid reassessment, there is no authority expressly condoning or prohibiting amendments to previously filed claim forms. In other words, if a claim from is filed in order to protect potential transferees, there is no formal means to change that claim once the transferees are finalized. The participants believed that providing a means to file amended claim forms would benefit taxpayers as well as assessors. Thus, the participants examined different approaches to address the issue.

Conclusion: Because claims for the exclusion must be made on a form prescribed by the SBE, the participants determined that the best way to address the issue was by modifying the SBE's basic form to indicate whether the filing was preliminary or final. The participants will coordinate with the division handling the SBE's forms to discuss the possibility of initiating a form revision process at the earliest possible date. In the meantime, however, the participants decided that it would be beneficial to circulate guidance advising assessors (and the public) of best practices when filing amended claims forms, including that amended claim

forms generally should be accepted as long as the form is to amend a transfer that was identified before specific asset distributions were finalized, and the form is filed within the statutory periods. It also would provide notice that a form revision process may be forthcoming, so that interested parties can start formulating what they would like to see in a revised form.

B. Sales Tax—Reporting Tax on Business Acquisitions When the Sales Price Is Contingent Upon Future Events

The second topic for discussion concerned the proper reporting of transactions that contain contingent sales prices.

Background: When all, or substantially all, of a business with tangible personal property is sold in a transaction that contains a contingent sales price, there may be uncertainty regarding the price of, or the gross receipts from, the sale of the tangible personal property (i.e., the taxable measure) to which sales or use tax applies. In addition, there may be uncertainty as to the period in which the sale should be reported, the amount to report, and whether there will be a need to subsequently file an amended return or claim for refund when the total taxable measure is fixed or determinable. This may be particularly true when the transaction includes the sale of taxable tangible personal property and other nontaxable property, including real estate, intangible property (i.e., copyrights, patents, goodwill, etc.), and tangible personal property, the sale and/or purchase of which is exempt from sales and use tax.

Development of the Issue: The participants shared their varied experiences in connection with business acquisitions involving prices that were contingent upon future events. Although the participants agreed that the parties often identify the sales price of the tangible personal property sold in connection with a business acquisition, the participants also agreed that the sales price of the tangible personal property is not separately identified in every purchase and sale agreement. Indeed, the participants agreed that the type of transaction that needed guidance was one involving the sale of a business with both taxable tangible personal property and other non-taxable property for a contingent sales price without a separately identified agreed upon sales price for the tangible personal property.

Analysis: The participants reviewed California's applicable sales tax statutes and regulations, excerpts from the SBE's Audit Manual, Sales and Use Tax Annotations addressing contingencies, the Financial Accounting Standards ("FAS") No. 5, and certain Internal Revenue Code provisions, and related Treasury Regulations, relevant to the reporting and allocation of purchase price in certain asset acquisitions.

The participants noted that subdivision (b)(1) of Sales and Use Tax Regulation 1595, *Occasional Sales—Sale of a Business—Business Reorganization*, generally explains that when there is a taxable sale of a business: (1) the measure of tax is the price agreed to by the parties for the sale of the taxable tangible personal property; and (2) where the parties have not agreed to a separately stated price for the taxable tangible personal property, then the measure of tax is determined by multiplying the total consideration received for the business by a fraction, the numerator of which is the selling price of the taxable tangible personal property, and the denominator of which is the selling price of the entire business. For this purpose, book value is regarded as establishing the price of the properties sold. With respect to (2), above, however, the participants noted that the regulation assumes that the total consideration received for the business is fixed, and there is no statutory or regulatory guidance as to how to determine the selling price of the tangible property when the total consideration is unknown at the time of the sale. It thus is unclear how to determine the proper measure of tax in a bulk sale of a business for a contingent sales price.

This leads to further uncertainty—e.g., how and when to report the taxable sale. Generally, a taxable sale must be reported on the return for the period in which the sale occurs. Yet, unless the proper measure of tax is fixed before the return is required to be filed for that period, there is no guidance as to whether a taxpayer must report the maximum possible sales price of the taxable tangible property or only the amount, if any, that is fixed at the time of sale. Thus, if the total consideration for the sale of the business increases upon the occurrence of a later contingency, it is unclear whether the taxpayer must file an amended return for the period in which the sale occurred to report a higher taxable measure. One participant expressed the view that, given the absence of any guidance, some taxpayers may report any such increase in the sales price of tangible property on the return for the period in which the total consideration paid becomes fixed.

The participants also noted that there was no guidance expressly setting forth the analysis that the BOE's audit staff should perform when they encounter transactions involving the acquisition of a business for a price contingent upon future events. For these reasons, the participants agreed that the best way to provide assistance would be to outline guidance for inclusion in a Policy Memorandum, to be issued by the BOE's Sales and Use Tax Department, and ultimately incorporated into the BOE's Audit Manual when it is updated in the future.

The guidance will define the term "contingency" in accordance with the definition provided by FAS No. 5 and

explain that the sales price of tangible personal property is contingent if it is subject to a contingency. The guidance will emphasize that the measure of tax is the price the parties agreed to for the sale of taxable tangible personal property included in the taxable sale of a business. The guidance will explain that when the parties have agreed to a specific price for the tangible personal property, the auditor should use that price to determine the taxable measure. The guidance will further explain that when the taxable tangible personal property is included in the sale of a business for a contingent sales price, any subsequent adjustment to the sales price of the business will not affect the sales price of the taxable tangible personal property unless the adjustment actually relates to the value of the taxable tangible personal property. (*See, e.g.*, Sales and Use Tax Annotation 395.0077, in which the separately stated consideration paid for the taxable tangible personal property included in a taxable sale of a business was subject to an adjustment related to the retail price of the business's output, and the BOE's Legal Department concluded that the separately stated consideration was not subject to a contingency because the adjustment did not relate to the value of the taxable tangible personal property.) Otherwise, the auditor should use the separately identified price to determine the taxable measure.

The guidance will further explain that when parties agree to the sale of a business for a contingent sales price but do not agree to a specific price for the taxable tangible personal property included in the sale, the auditor should determine the taxable measure by following the procedures set forth in section 1004.25 of the Audit Manual for determining the sales price of tangible personal property included in a bulk sale. Those procedures advise auditors to determine the sale price of taxable tangible personal property by looking to one of four indicia of value (book value, the appraised value for property tax purposes, the value determined by an independent appraisal, and the taxpayer's estimate) and then using at least one of the remaining three indicia to verify the accuracy of the value indicated by the first indicia. The participants agreed that in instances where there is a bulk sale of a business and the parties have not agreed to a specific price for the taxable tangible personal property, the parties have implicitly agreed to buy and sell the taxable tangible personal property at its current value, regardless of whether the total selling price is fixed at the time of sale or is subject to a contingency. The participants further agreed that in such cases, the value of the tangible personal property—and thus the measure of tax—generally will be equal to the book value of such property. In addition, the participants agreed that because the value of tangible personal property can be determined by reference to its book value at the time of a bulk sale, the taxable measure from the bulk sale should be reported on the return for the period in which the sale occurred.

Conclusion: The participants agreed that a Policy Memorandum should be issued to the BOE's audit staff explaining how it should evaluate sales tax liabilities in transactions involving a contingent sales price for the acquisition of a business enterprise possessing both taxable tangible personal property and other property consistent with the analysis set forth above. The participants also agreed that a Special Notice should be issued to the public, in conjunction with the issuance of the Policy Memorandum to staff, in order to inform the public about the guidance provided to staff.

III. FRANCHISE AND INCOME TAX COMMITTEE

A. Possible Legal Ruling Regarding Inclusion of Certain Non-Insurance Activities of a Non-California Insurer in a California Franchise Tax Combined Report

The first topic discussed was to what extent should an insurer, either nonadmitted or not engaged in insurance business in California, be included or excluded from the California combined reporting group of any affiliated non-insurer California taxpayer(s)? To what extent should the answer to the previous question depend upon whether that entity is "doing business," but not doing "insurance business," in California? Can a stand-alone nonadmitted insurer be subject to the Franchise Tax? How should an admitted California insurer be treated as a corporation for franchise or income tax purposes, such as elections or dividends, in light of the definition of "corporation" provided by Revenue and Taxation Code section 23038(a)?

Background: Article 13, Section 28 of the California Constitution provides in relevant part:

> (a) "Insurer," as used in this section, includes insurance companies.... As used in this paragraph, "companies" includes persons, partnerships, joint stock associations, companies and corporations.
>
> ....
>
> (f) The tax imposed on insurers by this section is in lieu of all other taxes and licenses, state, county, and municipal, upon all such insurers and their property, except: (1) taxes on their real estate. (2) [the trust department of an insurer conducting title insurance in this State is taxed the same as trust departments of trust

companies and banks doing business in this state].

California Revenue and Taxation Code ("RTC") section 23037 provides:

> "Taxpayer" means any person subject to the tax imposed under Chapter 2 (commencing with Section 23101), Chapter 2.5 (commencing with Section 23400), or Chapter 3 (commencing with Section 23501).

RTC section 23038(a) provides:

> "Corporation" includes every corporation except corporations expressly exempt from the tax by this part of the Constitution of this state.

In 1975, the FTB issued Legal Ruling No. 385 ("LR 385"), which recognized the constitutional exclusion from franchise tax of insurance companies "operating in this state" and the resulting exclusion of "corporate insurers" from the definition of "taxpayer" as defined in RTC section 23037. In applying these principles to formula apportionment of RTC section 25101 unitary income, LR 385 proclaimed that the income and factors of corporate insurers operating in California must be excluded from the combined report of taxpayers, even if they are unitary with such taxpayers. Notably, "in accord with the established departmental practice of uniform treatment on basically similar facts," LR 385 also called for the exclusion of insurance companies operating entirely outside California.

In 1990, the California Supreme Court decided *Mutual Life Insurance Company of New York v. City of Los Angeles*, 50 Cal. 3d 402, popularly known as *MONY*. That case unequivocally held that the "in lieu" clause in Article 13, Section 28(f) of the California Constitution was absolute: "If the insurer does no insurance business here, there are no gross premiums received and section 28 does not apply. If the insurer does business [in California], section 28 does apply and the insurer pays the gross premiums tax on its [California] insurance business" and is exempt from California state and local taxes of any kind (other than the specifically enumerated exceptions).

Discussion: Eagle Lodge West attendees discussed the fact that LR 385 did not expressly cover insurance companies operating *both within and without* California. The discussion focused mainly on whether and to what extent the non-insurance income and factors of such companies were subject to franchise tax/inclusion in a combined report with their unitary affiliates.

Given the *MONY* decision, those in attendance universally acknowledged that writing California insurance policies and paying the resulting gross premiums tax triggered the *in lieu* provision. That left open for discussion just one circumstance: Companies that had insurance business outside California, and non-insurance business inside California, whether both lines of business were in the same legal entity or not (e.g. an out-of-state insurance corporation owning a disregarded LLC that operates an in-state for-profit parking lot).

It was initially posited that because Section 28 and *MONY* only covered in-state insurance businesses, there was no legal authority to prevent California franchise tax from applying to the in-state non-insurance operations (such as an in-state parking lot) of an out-of-state insurance company. On the other hand, California taxation in this circumstance seems fundamentally inconsistent with LR 385's exclusion from a combined report of the income and factors of an out-of-state insurance company that operated, for example, an out-of-state parking lot. If the in-state parking lot (held by an out-of-state insurance company) is subject to franchise tax, then the out-of-state parking lot's income and factors should also be included, contrary to LR 385. In response, there was a brief discussion about whether LR 385 should be withdrawn entirely, though ultimately the idea of removing a 37-year-old ruling was seen as unlikely to occur.

Those in attendance also discussed whether taxation of an in-state non-insurance line of business owned by an out-of-state insurance company would discriminate against interstate commerce. That is, taxation in this circumstance while simultaneously exempting from franchise tax an identical business that operates wholly within California would violate the Commerce Clause of the U.S. Constitution. Although the McCarran-Ferguson Act, 15 U.S.C. §§ 1011-1015, generally carves out insurance from Commerce Clause protection, it was mentioned that the proposed interpretation/application of the laws would result in higher California tax for the insurance company's non-insurance affiliates – which do enjoy Commerce Clause protection. It was suggested that this was the legal authority that was previously mentioned as non-existent.

Finally, there was a discussion about how "insurance" is defined. California's Department of Insurance ("CDI") regulates insurance companies that are formed or admitted in this state, but less clear was how to treat out-of-state companies. In 1977, the California Supreme Court decided *Scott Beamer v. Franchise Tax Board*, 19 Cal. 3d 467. The issue was whether a Texas tax was an income tax or not. The Court held that California standards should be used to answer the question. If the same principle were applied in the insurance company context, whether out-of-state companies are treated as insurance companies for California franchise tax purposes would depend on whether

such companies *would, hypothetically*, be regulated by the CDI *if* they operated in California. It was noted that there was a relative lack of legal authority both in support of and in opposition to this suggested treatment. In EDS Corporation's non-published BOE appeal, in its effort to exclude an out-of-state subsidiary from the taxpayer's combined report, the FTB had argued that the subsidiary's Texas Medicaid underwriting activity would have triggered California gross premiums tax if conducted in California, but the taxpayer disputed this.

Conclusion: Ultimately, the FTB may consider issuing a legal ruling on the franchise tax treatment of companies that conduct an insurance business outside California and a non-insurance business inside California.

B. Business/Nonbusiness Income/Losses

Issue: Next, the participants discussed whether a legislative change to RTC section 25120's definition of "business income" to "all income apportionable under the United States Constitution" would be beneficial.

Discussion: It was noted that some other states, such as North Carolina, have already made this change. A policy factor mentioned as weighing in support of such a change was no longer considering how a taxpayer uses the proceeds of a sale as a factor in determining whether the income is apportionable. Also, it was said that the "functional test," which comes from the current statute, creates excessive debate and uncertainty about terms such as "acquisition," disposition," "transactions and activities," and "regular trade or business," and whether the "acquisition, management, and disposition" of property was "integral" to a taxpayer's regular trade or business operations. The constitutional standard, with its emphasis on whether the income comes from assets that "serve an operational rather than an investment function," was thought to be easier to understand and administer. A consequence of adopting a new standard for determining business/nonbusiness income issues was the fact that there are few court cases that help define the scope of this "long-arm" approach. Some participants found comfort in the existing body of case law, rulings, and other guidance that currently exist, and were not anxious to discard this body of precedents. Further, it was acknowledged that any change to the existing statutory definition would require a two-thirds vote of the legislature, which may be difficult to achieve. A suggestion was made that in lieu of a legislative change, Regulation 25120 could be updated to reflect the current state of California case law.

C. Possible Taxpayer Guidance Concerning California Franchise Tax Treatment of Federal Financial Assistance Provided by FDIC with Respect to Loan Assets Acquired from Failed Banks

Finally, the participants discussed to what extent there may be a position under existing California Franchise Tax ("CFT") provisions to allow for the tax treatment of FDIC-subsidized loans in a manner that conforms with the provisions of Internal Revenue Code ("IRC") section 597 and the regulations thereto. Specifically, participants considered how Purchase and Assumption transactions should be treated under California law with respect to allocation of tax basis, including Covered Assets and loss sharing agreements, and whether guidance in the form of a Legal Ruling and/or transition relief might be possible.

Background: The Treasury Regulations authorized by IRC section 597 authorized the Treasury to provide special rules for the allocation of initial basis to assets acquired by an institution with Federal Financial Assistance ("FFA") from a failed bank. Such acquisitions take place in transactions regulated by the FDIC as documented in a "Purchase and Assumption" agreement. Among other provisions, the FDIC typically provides a loss guarantee, or Loss Share Agreement ("LSA"), often up to 80 percent or 80 percent up to a stated amount, and 95 percent thereafter. Provision of a loss guarantee enables the FDIC to induce acquirers to take on the loans making FDIC's role more efficient and cost-effective to the public.

Treasury Regulation sections 1.597-1 through 1.597-8 treat all such acquisitions as asset acquisitions subject to general purchase price allocation rules under Treasury Regulation section 1.338-6, but specifically designate Covered Assets (including assets covered by an LSA) as Class II assets with no separate allocation for the LSA. Those rules also provide that the fair value of the Covered Assets is no less than the Highest Guaranteed Value of the asset and that, to the extent that amount exceeds the purchase price, the acquirer must take the difference into income over six years. In addition, in those situations where federal financing is provided, such is not included in basis until such amounts are repaid.

California conformed to IRC section 597 for transactions occurring prior to December 31, 1988, but conformity has not been updated to account for the existence of the FDIC (the prior version of Section 597 to which California RTC section 24322 conformed referred to a predecessor agency), nor for the current situations facing failed and acquiring banks.

Conclusion: Eagle Lodge West attendees agreed that since the specific provisions for Highest Guaranteed Value and six-year income inclusion have no California law equivalents,

it would be problematic to allow similar treatment to that extent absent a statutory change. For the same reason, the attendees agreed that the normal rules relating to the determination of basis would apply such that the portion of the purchase price financed by the federal government would be included in basis from the time of the transaction. As for the treatment of the LSAs, some attendees identified substantial federal authority, which California would seem to follow, for treating the loans and LSAs, i.e., the Covered Assets, as embedded assets rather than separate assets with separate basis. FTB participants indicated that it would be appropriate to issue guidance to taxpayers sooner rather than later and that it may be possible to issue such guidance in the form of a Legal Ruling to clarify the treatment of these transactions for CFT purposes.

Possible Future Action: It was also discussed that some taxpayers may have taken the federal treatment for CFT purposes for administrative ease or, in the absence of guidance, may have taken other approaches. Participants considered whether the "597 position" or those other approaches could be treated as an accounting method and allow taxpayers to make an accounting method change from the "597 position" or other approaches to adopt the California treatment as described in the Legal Ruling. A conclusion was deferred pending additional research into that aspect.

Visiting the Committees

Commentary and Updates by the Committees

Some Quick Points

The following are selected brief technical updates, procedural updates, observations on practice or policy matters, and commentaries presented by members of the Standing Committees.

STATE AND LOCAL TAX COMMITTEE

Taxpayer Victory in *Gillette*? Not So Fast...

On August 9, 2012, the California Court of Appeal for the First District vacated, on its own motion, its July 24, 2012 opinion and ordered a rehearing in *The Gillette Company v. California Franchise Tax Board,* Case No. A130803. The now vacated opinion had held that most California taxpayers may elect to apportion income pursuant to the Multistate Tax Compact ("MTC") provisions codified in California Revenue & Taxation Code ("R&TC") section 38006. The MTC provisions provide for the use of an equally weighted three-factor apportionment formula (property, payroll and sales), rather than the standard double-weighted sales factor formula generally otherwise applicable. On August 8, 2012, the Franchise Tax Board filed a Petition for Rehearing to resolve whether the court's opinion conflicted with established principles of statutory construction and, in the alternative, whether the court's opinion determined that R&TC section 25128 was unconstitutional. Also on August 8, 2012, the taxpayers filed a Request to Modify the Opinion for a "non-substantive modification" to clarify the court's statement in the July 24 opinion that any legislation repealing the MTC provisions must be prospective in nature. Specifically, the taxpayers requested language stating that, for the tax years at issue, California had not repealed R&TC section 38006 and withdrawn from the MTC provisions. This clarification was sought because of the attempted repeal of the MTC provisions by Senate Bill ("S.B.") 1015, which was enacted on July 28, 2012. Further, taxpayers requested that any reference to S.B. 1015 be accompanied with a statement that the court expresses no opinion on the validity of S.B. 1015. A taxpayer challenge to the validity of S.B. 1015 may be lurking because it was passed with a simple majority vote rather than the two-thirds super-majority required for tax increases according to amendments made to the California Constitution by Proposition 26. The rehearing was ordered on the Court's own motion without granting either party's petition and with no indication of the issues to be resolved.

- Matthew B. Johnson, San Francisco, CA

TAX EXEMPT ORGANIZATIONS COMMITTEE

ACT Recommends Substantial Changes to Form 1023

The Internal Revenue Service's (the "IRS's") Advisory Committee on Tax Exempt and Government Entities ("ACT") held a public meeting on June 6, 2012 and issued its annual report. In the report, ACT recommended that the IRS devote the necessary resources to make the Form 1023 an interactive web-based form that can be transmitted electronically. ACT also recommended that the IRS redesign the Form 1023 to make the form; (1) more effective at identifying whether an organization meets the requirements for exemption; (2) more consistent with the Form 990; and, (3) contain a simplified format for small/less complex organizations. ACT also recommended that the IRS develop more educational tools about the Form 1023, including more information about the substantive requirements for recognition of exemption.

- Rebecca O'Toole, Rancho Santa Fe, CA

Notice 2012-52, IRS Confirms Deductibility of Charitable Contributions to Disregarded Entities

For many years, tax-exempt organization practitioners have argued that because a single-member limited liability company that is wholly owned by a tax-exempt organization ("SMLLC") is disregarded for tax purposes, donors to such an entity should be treated as though they made a donation directly to the tax-exempt parent organization.

On July 31, 2012, the IRS issued Notice 2012-52, which provides long awaited confirmation that a charitable contribution to a SMLLC will be deductible for US federal tax purposes to the same extent as a contribution made directly to the SMLLC's sole member, the tax-exempt organization. The notice is effective for charitable contributions made on or after July 31, 2012.

- Rebecca O'Toole, Rancho Santa Fe, CA
and Cecily Jackson-Zapata, Los Angeles, CA

TAX PROCEDURE AND LITIGATION COMMITTEE

FBAR and Willfulness Update: *United States v. Williams,* 2012 U.S. App. LEXIS 15017 (4th Cir. Va. July 20, 2012) (unpublished)

In an unpublished opinion, the Fourth Circuit reversed a District Court's judgment that for civil penalty purposes, Williams did not willfully fail to report his interest in two foreign bank accounts under 31 U.S.C. section 5314. In reaching its decision, the court cited multiple admissions made by Williams in an allocation as part of his plea for evasion of taxes charges, including that he chose not to report the income, he knew he had the obligation to report the existence of the Swiss accounts, and he knew what he was doing was wrong and lawful. The court also addressed how Williams "checked no" regarding having any interest in foreign accounts on both his tax return organizer and on his federal tax return.

Ultimately, the court determined that Williams' conduct in not paying attention to reference to the Form TD F 90-22.1 (the "FBAR") on the tax return, together with his "false" answers on both the tax organizer and his federal return, constituted "willful blindness" to the FBAR filing requirements. The majority's rationale noted that Williams' allocutions further confirmed that his violation was willful, although the dissent noted incongruence between the facts in Williams' guilty plea to tax evasion and the facts necessary for proving a willful violation of failing to an FBAR. In the end, the two-judge majority found that the District Court clearly erred in finding that Williams did not willfully violate 31 U.S.C. section 5314, reversed its judgment, and remanded the case.

- Cory Stigile, Beverly Hills, CA

YOUNG TAX LAWYERS COMMITTEE

Patient Protection and Affordable Care Act Upheld by the Supreme Court, and How We'll Pay for It

On June 28, 2012, the Obama Administration was successful in its battle to have the Supreme Court uphold most of the provisions of the Patient Protection and Affordable Care Act of 2010 (the "PPACA"). In an effort to fund the PPACA, beginning January 1, 2013, taxpayers at higher income levels will feel the pinch of the new taxes included in the bill, which initially passed in March 2010.

The first tax is a 0.9 percent increase in the Medicare Hospital Insurance Tax portion of FICA on wages over $200,000 ($250,000 for couples, $125,000 for married filing separately). Generally, every wage earner owes a 2.9 percent tax, which is split between the employee and the employer. Under the new tax, the additional 0.9 percent, which brings the total Hospital Insurance Tax for these high earners to 3.8 percent, is payable entirely by the employee. Self-employed persons will be equally affected by a 0.9 percent increase in the Hospital Insurance Tax portion of the SECA tax on self-employment, subject to the same income limits.

The second tax, called the Unearned Income Medicare Contribution Tax, is a 3.8 percent flat tax on the lesser of net investment income, or the excess of Modified Adjusted Gross Income over the threshold amount of $200,000 (or $250,000 for couples, $125,000 for married filing separately). Investment income is a broad category including, but not limited to, most interest, rents, dividends, royalties, capital gains from the sale of stocks and bonds, and passive rental and business income. Even taxable gain on the sale of a home is hit by this new tax to the extent the gain exceeds the Section 121 exclusion for the sale of a principal residence. The tax on investment income not only affects individual taxpayers, but also can have a significant effect on income taxes owed by trusts and estates.

The effort to raise revenue to pay for the costly healthcare act has made two very significant changes to the tax system. Historically, the tax on wages to fund Medicare has been a flat tax and has only been imposed on earned income. The new 0.9 percent tax will impose a progressive Medicare Hospital Insurance Tax on wages, and the new Unearned Income Medicare Contribution Tax of 3.8 percent will impose a Medicare tax that previously did not exist on investment income.

- Autumn Ronda, Los Angeles, CA

Testamentary Power of Appointment to Appoint to a Class Consisting of Issue of Settlors Not a Taxable General Power of Appointment: PLRs 201231007 and 201229005

In Private Letter Rulings ("PLRs") 201231007 and 201229005, the IRS put to rest (for now) the question of whether or not a testamentary power of appointment in favor of a class of persons that includes the power holder is a taxable general power of appointment. The facts are as follows: settlors established an irrevocable trust for the benefit of their two sons. The trust was split into equal trusts for both sons. Each son was then granted a testamentary power to appoint trust principal and income to a class consisting of the issue of the settlors, which included themselves.

Each son requested a ruling that the testamentary power of appointment granted to him was not a taxable general power of appointment under Section 2041(b)(1), which provides that a "general power of appointment" is a power exercisable in favor of the decedent, his estate, his creditors and the creditors of his estate. If the power is a general power

of appointment, the power would result in the inclusion of principal and any accrued and undistributed income in the decedent's gross estate.

The IRS concluded that although each son had the power to appoint to himself as a member of the class consisting of the issue of his parents, because the power was testamentary, the power was not a taxable general power because the sons could not appoint the assets to themselves or their creditors during their lifetimes. The PLRs concluded that a class of permissible appointees "is properly viewed as not including Son's estate or the creditors of Son's estate after Son's death." Despite this favorable tax ruling, because the conclusion could change, it is advisable that the power of appointment be explicit in providing that the power can only be exercised in favor of the living issue of the settlors or, expressly deny the ability to exercise the power in favor of the power holder's estate.

- Dawn M. Keeney, Los Angeles, CA

Where to Draw the Line: Taxation of Nobel Prize Winnings but Not Olympic Winnings

On August 8, 2012, California lawmakers introduced legislation that would exempt Olympic athletes from paying state tax on their medals and cash winnings. The U.S. Olympic Committee awards Olympians $25,000 for gold, $15,000 for silver, and $10,000 for bronze medals. Under current law, both the IRS and the State of California impose a tax on the medals and prize money won by Olympians residing in California as income earned for services performed overseas. According to one of the authors of the bill, Republican Member of the Assembly Allan Mansoor, gold medal winners would have to pay an estimated $1,450 in California state taxes.

California Olympians represented an estimated 25 percent of the entire Olympic delegation, the largest of any state, and despite the current California revenue crisis, the bill has found support with a number of Assembly members. The federal government is also taking action to prevent Olympic winnings from being taxed. Senate Bill 3471, the Olympic Tax Elimination Act, has been introduced to eliminate the tax on Olympians' winnings. The proposed legislation has gained support from President Obama.

The California bill raises questions about where the line should be drawn. If we allow Olympians to avoid taxation on their medals and prize money, should we also exempt Nobel Prize winnings from taxation? When asked by one of Tax Analysts reporters, Assembly Member Curt Hagman differentiated the two classes of prizewinners by stating Olympic athletes "are amateurs and are doing it because it's their passion," while Nobel Prize Winners are "doing their jobs and professions."

- Neda R. Barkhordar, Los Angeles, CA

Fees for IRS Written Determinations?

The IRS recently published updated guidelines for taxpayers interested in obtaining documentation and information on fees charged for written determinations such as letter rulings, determination letters, and technical advice. A taxpayer may request background information related to the request, to include, the request for written determination, material submitted in support of the request, as well as any communication between the IRS, the requestor, and third parties related to the request. Communications between the IRS and the Department of Justice relating to a pending civil or criminal investigation are excluded.

Revenue Procedure 2012-31, effective for requests after September, 30, 2012, supersedes Revenue Procedure 95-15, 1995-1 C.B. 523. Revenue Procedure 2012-31 provides the request must be in writing and state the file number of the written determination for which the document is being requested. Further, the request should specify what information is being sought, if not the entire file, and indicate the maximum amount of charges that are agreed to be paid without further authorization. The fee for processing requests is $100 per hour including the time to conduct the search, make deletions, and copy the documents. If the request does not authorize a maximum that will be paid or if fulfilling the request will exceed the maximum, the IRS will send the requestor a payment agreement with the estimated cost that must be signed and returned to the IRS before it will begin processing the file. Revenue Procedure 2013-31 states that it will take 90 to 120 days to process requests.

- Adria Price, Half Moon Bay, CA

Debt Limitations for Qualified Residence Interest: *Sophy v. Comm'r*, 138 T.C. No. 8 (2012)

In March 2012, the Tax Court interpreted the Section 163 limitations on acquisition and home equity indebtedness to apply on a per-residence basis, rather than on a per-taxpayer basis. This ruling significantly restricts a taxpayer's ability to deduct interest when purchasing a residence with another taxpayer; however, the application of the indebtedness limitations of Section 163 for qualified residences of taxpayers appears unresolved.

The acquisition and home equity indebtedness limitations of Section 163 limit the deductible interest to the amount of interest paid on $1.1 million of "qualified residence interest," defined as $1 million of acquisition debt plus $100,000

of home equity debt, provided the debt is secured by the residence. The statute, however, is not clear regarding the application of such limitations.

In *Sophy*, the Tax Court analyzed the wording of the indebtedness limitations of Section 163. The court noted that the definitions of acquisition and home equity indebtedness use the phrase "any indebtedness" and identified this phrase to be the operative statutory language. The court also noted that "any indebtedness" is not qualified by language concerning an individual taxpayer. Accordingly, the court determined the focus should be on the entire amount of the indebtedness.

Section 163 does not define "qualified residence," but incorporates the meaning of "principal residence" from Section 121 and the meaning of "one other residence" from Section 280A. Under Section 121, when there are two or more unrelated owners of the same property, each is considered to own an undivided interest in a separate principal residence and the exclusion is applied to each separately owned portion of the property. Therefore, it seems unreasonable to treat unrelated joint owners as each owing a separate principal residence under Section 121 and not under Section 163, especially given that the meaning of a qualified residence for purposes of Section 163 requires the use of Section 121.

In *Sophy,* it appears the Tax Court chose to rely on an IRS field service advice memorandum (FSA 200137033) rather than legislative history or the relationship between Section 163 and Sections 121 and 280A. However, because the Tax Court failed to address whether the relationship of the joint owners or the type of ownership had any impact on the decision, the application of the indebtedness limitations of Section 163 for qualified residences is unsettled.

-Aubrey Hone, San Francisco, CA

Voluntary Classification Settlement Program Still Provides Great Benefits

In late 2011, the IRS issued Announcement 2011-64 and launched a new program for taxpayers to voluntarily address misclassified workers. The Voluntary Classification Settlement Program (the "VCSP") is an optional process for taxpayers to reclassify independent contractors as employees for future tax years much like the IRS's Classification Settlement Program, and still provides a great benefit to many taxpayers. The advantage of the VCSP is as follows: in exchange for agreeing to prospectively treat a class of workers as employees for future tax periods, a taxpayer pays only 10 percent of the employment tax liability for the most recent tax year. Furthermore, the taxpayer will not be liable for any interest and penalties on the liability, and will not be subject to an employment tax audit with respect to the worker classification of the workers for prior years. If a taxpayer is currently treating its workers as independent contractors and wants to take advantage of the VCSP, certain eligibility conditions apply. First, a taxpayer must have consistently treated the workers as nonemployees, filing all required 1099's for the last three years. Second, the taxpayer cannot be under audit by the IRS or another government agency for worker classification issues. If eligible, a taxpayer can participate in the program by filing Form 8952 at least 60 days before the date it wants to begin treating the class of workers as employees.

-Kevan P. McLaughlin, San Diego, CA

IRS Confirms Deductibility of Contributions to Domestic LLCs Wholly Owned By Charities

The IRS issued Notice 2012-52 to provide guidance on the deductibility of contributions to domestic single-member limited liability companies that are wholly owned and controlled by organizations described in Section 170(c)(2) of the Internal Revenue Code (U.S. charities) and for federal tax purposes are disregarded as entities separate from their owners under Section 301.7701-2(c)(2)(i) of the Procedure and Administration Regulations (SMLLCs). The notice provides that "if all other requirements of Section 170 are met, the IRS will treat a contribution to a disregarded SMLLC that was created or organized in or under the law of the United States, a United States possession, a state, or the District of Columbia, and is wholly owned and controlled by a U.S. charity, as a charitable contribution to a branch or division of the U.S. charity. The U.S. charity is the donee organization for purposes of the substantiation and disclosure required by Sections 170(f) and 6115." This notice is effective for charitable contributions made on or after July 31, 2012. However, taxpayers may rely on the notice prior to its effective date for taxable years for which the period of limitation on refund or credit under Section 6511 has not expired.

-Julie Wann, San Jose, CA

Committee Profiles

Presented below are brief introductions to three of the Standing Committees highlighted in this issue of *California Tax Lawyer*.

INCOME AND OTHER TAXES COMMITTEE

The Income and Other Taxes Committee provides an outlet for its members to actively participate in the Section with respect to issues relating primarily to federal income taxation. The Committee's mission is to (1) promote dialogue and maintain the expertise of its members through the annual provision of continuing education with respect to recent developments on various income (and other) tax issues; and (2) provide a networking forum for members to expand their professional contacts.

STATE AND LOCAL TAX COMMITTEE

The State and Local Tax Committee assists the Taxation Section and the State Bar of California in developing valuable, informative, high quality continuing legal education programs. In addition, the State and Local Tax Committee strives to become an important resource for local bar associations across California who need assistance planning, developing, and promoting continuing legal education programs and activities related to state and local tax topics. Finally, the Committee continually seeks opportunities to work with California's taxing agencies to address important issues affecting both taxpayers and the government.

YOUNG TAX LAWYERS COMMITTEE

The Young Tax Lawyers Committee ("YTLC") is composed of an executive board that works with regional chapters to provide education and support for new tax lawyers throughout California. The purpose of the YTLC is to provide opportunities for new tax lawyers to further their personal and professional development through participation in Taxation Section activities. Local chapters hold periodic meetings on current tax developments and facilitate educational talks on noteworthy tax topics while providing networking opportunities to meet fellow young tax attorneys and to meet more senior tax practitioners who often speak at the meetings. There are presently chapters in Los Angeles, Sacramento, San Diego, Silicon Valley, and the San Francisco Bay Area.

GET INVOLVED!

The Taxation Section relies on the energy, effort, and dedication of the members of the California tax practitioner community. We encourage all members of the Taxation Section to get involved in the section—***your*** section.
Here are some things you can do right now:

- Apply for a position on the Taxation Section Executive Committee
- Propose a program for the 2013 State Bar Annual Meeting
- Propose a program for the 2013 Annual Meeting of the California Tax Bar and California Tax Policy Conference
- Propose a topic for the 2013 Washington, D.C. Delegation
- Write an article or short piece for the California Tax Lawyer
- Become active in a Standing Committee

For more information on these activities and who to contact about them, please see the Taxation Section Overview, supra.

Committee Activities

Presented below are short updates on various activities of the Standing Committees.

The **Compensation and Benefits Committee** is continuing its efforts to institute quarterly conference calls for all members interested in the topics that affect compensation and benefits. Members interested in participating or providing comments should contact the Committee Chair, Jeremy M. Pelphrey, at jmpelphrey@pensionlawyers.com or Committee Chair-Elect, Yana S. Johnson, at yjohnson@mofo.com.

The **Corporate and Pass-Through Entities Committee** held its fourth quarterly meeting on June 7, 2012 *via* teleconference. The meeting included a discussion of the 2012 Washington D.C. Delegation, announcement of future events and elections for officer positions. Congratulations to the following individuals who were elected to the 2012-2013 term. *Chair*: Stephen Turanchik, Paul Hastings LLP, Los Angeles; *First Vice Chair*: TBD; *Second Vice Chair*: Greg Zbylut, Zbylut Law Office, Pasadena; *Third Vice Chair/Newsletter Editor*: Ulises Pizano-Diaz, Law Offices of Williams & Associates, Sacramento; *Education Chair*: Laura Buckley, Higgs Fletcher & Mack, San Diego; *Member at Large*: Jason Choi, Latham & Watkins, Singapore. The Committee's next quarterly meeting will be held from 12:00 to 1:00 p.m. on September 28, 2012 *via* teleconference. An agenda will be circulated to committee members shortly before the meeting. If you are interested in speaking at an event or presenting a CLE, please contact Chair Stephen Turanchik at stephenturanchik@paulhastings.com.

The **Estate and Gift Tax Committee** participated in the first California Solo & Small Firm Summit held in Long Beach on June 21-23, 2012. At the conference, Committee Advisor, Donna Herbert, and Committee Chair, Robin Klomparens, spoke on current estate and gift tax developments. The Committee's topic, *What Every Practitioner Needs to Know about IRS and Practicing before the Tax Court*, and panel were very well received.

The Committee is excited about its active participation in two upcoming annual conferences. At the State Bar of California 85th Annual Meeting in October 2012, the Committee will present on two topics: *Life Insurance Planning in Today's Environment* and *When Trust Administration Goes South.* This annual meeting is a wonderful conference where practitioners of all disciplines have an opportunity to rub elbows and learn from one another. At the Annual Meeting of the California Tax Bar & the California Tax Policy Conference in November 2012, there will be ten estate and gift tax topics, including an ethics program. There will be many speakers from all over the country including several participants from Washington D.C. The speakers run the gambit from private practitioners, tax court judges, and government participants. James Hogan, IRS Branch Chief of Estate and Gift, will also be speaking at this annual meeting. The Committee looks forward to him speaking again as he was extremely well received at the Committee's conference in March 2012. Of course, there will be three days of varying tax topics from all tax areas. So, participants can explore programs and panels outside of the estate and gift arena. Last year, we had several hundred attendees. When the flyers come out, make sure to secure your reservations! Please contact the Committee Chair, Robin Klomparens, at rklomparens@wkblaw.com for information on joining the Committee and future events.

The **Income and Other Taxes Committee** held its all-day Income and Other Taxes Committee's Annual Income Tax Seminar on June 22, 2012 at three simultaneous locations: (1) Golden Gate University School of Law, San Francisco, CA (Northern); (2) Whittier Law School, Costa Mesa, CA (Central); and (3) the University of San Diego School of Law, San Diego, CA (Southern). This was the first year holding the conference in San Diego. Overall, the event was a complete success with excellent attendance, excellent speakers, interesting subjects, and a low cost way of receiving MCLE and CPA credits. Please contact the Committee Chair, Ciro Immordino, at ciro.immordino@ftb.ca.gov for information on joining the Committee and further events.

The **International Tax Committee** held a telephonic meeting on Wednesday, March 14, 2012. Topics discussed included summaries of 2012 Washington DC Delegation papers proposed by the Committee and a discussion of current international tax topics, including the proposed FATCA regulations. Please contact the Committee Chair, Allen Walburn, at awalburn@allenmatkins.com for information on joining the Committee and further events.

The **Tax Exempt Organizations Committee** held an in-person meeting on July 17, 2012 at the Westin San Francisco Airport Hotel. The meeting included representatives from the California Secretary of State and the California State Board of Equalization and the Nonprofits Committee of the Business Law Section.

The TEO Committee holds occasional phone meetings, in addition to regular joint meetings with the Business Law Section Nonprofit Organizations Committee. The next phone meeting will be held in September (date TBD). The next in-person meeting will be held on November 30, 2012 at the Los Angeles Marriott Downtown at 1:00 p.m. This meeting is held in conjunction with the Loyola Law School and IRS sponsored Western Conference on Tax Exempt Organizations. Please contact the current chair of the TEO Committee, Rebecca O'Toole, at rotoole@mckennalong.com or (818) 609-7761 for information on joining the Committee and further events.

The **Tax Policy, Practice and Legislation Committee** held a conference call on July 20, 2012, to discuss current projects. The Committee has another call scheduled for August 17, 2012, to discuss plans for the Committee for the upcoming year, including the Annual Meeting of the California Tax Bar & the California Tax Policy Conference in November 2012. The Committee tentatively agreed to meet again on or around November 1-3, 2012, to coincide with the annual meeting in San Diego.

The **Tax Procedure and Litigation Committee** will hold its next quarterly meeting on September 7, 2012 in San Francisco, at the offices of Winston & Strawn LLP. The Committee will host a panel discussion on preparer, promoter and material advisor enforcement, with representatives from the IRS, FTB, and private practitioners sharing insights on these topics. Please contact the current chair of the Tax Procedure and Litigation Committee, David Klasing, at dave@taxesqcpa.net for more information about upcoming meetings or joining the Committee.

The **Young Tax Lawyers Los Angeles Chapter** hosted a breakfast presentation on June 28, 2012, titled "State Taxes and Nexus: Basic Framework and Recent Developments", presented by Ryan M. Austin of Loeb & Loeb LLP. Please contact the Committee Chair, Autumn Ronda, at ar@vrmlaw.com for information on joining LA-YTL and future events.

Young Tax Lawyers Sacramento Chapter Meeting
May 17, 2012 in Sacramento, CA

Tim Gustafson, Associate with Sutherland Asbill & Brennan LLP, John O. Johnson, Tax Counsel at State Board of Equalization, and other attendees

The **Young Tax Lawyers Sacramento Chapter** hosted a luncheon event on May 17, 2012. Tax attorneys John Johnson from the Board of Equalization and Tim Gustafson from Sutherland spoke about the BOE appeal process. On June 21, 2012, Sac-YTL hosted an evening event on the topic of "A Tax Attorney's Guide to Accounting" presented by attorney BJ Susich from Boutin Jones. The chapter will host its next event in the fall of 2012 and feature its annual end-of-the-year mixer in October. Committee meetings are generally held on the third Thursday of every other month. Interested parties can go online to "http://groups.google.com/group /Sac-YTL" in order to find out more and to stay informed. The chapter has a Facebook page, as well as a LinkedIn page, and welcomes online participation.

The **Young Tax Lawyers San Francisco Bay Area Chapter** has had very busy and exciting spring and summer seasons! BAYTL kicked-off the spring season with the co-sponsored annual post-April filing networking happy hour and a panel discussing the benefits of pursuing and obtaining an LL.M. in taxation. Soon after, BAYTL was proud to co-sponsor the panels "Navigating Federal and State Tax Liability from Inception to Appeal" and "Estate Planning 101: for Business Owner Clients." In addition, BAYTL co-hosted "Rainmaking: Tips & Tactics" in July and the 2nd Annual Tax Speed Networking event in August. BAYTL was also proud to welcome four new members onto its already strong and vibrant executive committee.

The **Young Tax Lawyers Silicon Valley Chapter** will host its next event in the fall of 2012. If you are interested in helping plan the fall and winter quarterly meetings to be held at Santa Clara University School of Law, we welcome suggestions for speakers and topics. The meetings are generally held at noon in Bannan Hall at the Santa Clara University School of Law, with lunch and one hour CLE provided free of charge to attendees.

The **Young Tax Lawyers San Diego Chapter** continues to host and sponsor tax meetings between experienced tax practitioners in the community, young tax lawyers and tax students. Attendance at the meetings continues to increase. The chapter will soon host discussions by leading practitioners on "Investigating Tax Crimes" and "International Structuring of IP: U.S. Businesses Abroad and Foreign Businesses Entering the U.S." The meetings are generally held at 7:45 a.m. the third Tuesday of each month in the Faculty Reading Room at the University of San Diego School of Law.

For additional information on any of the Standing Committees and their activities, please contact one of the officers of the committee. Please refer to the Taxation Section Leadership Directory, infra, *for contact information for the various committees. For information on how to join any of the Standing Committees, please see the Taxation Section Overview,* supra.

Taxation Section 2012-2013 Leadership Directory

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Online CLE for Participatory Credit Is Now Available Anytime!

Past Taxation Section programs are available over the internet for participatory CLE credit. For more information and a full listing of all of the Taxation Section's Online CLE programs, visit the following link and select 'Taxation' as the subject area:

http://www.legalspan.com/calbar/catalog.asp

Here are a few recent programs, available at your finger tips:

- **New Developments in Partnership and Real Estate Taxation: The Government's Perspective**
- **Estate Planning with Non Citizens**
- **Foreign Investment in U.S. Real Estate**
- **Question & Answer – from the 2012 Annual Estate & Gift Tax Conference**
- **Between a Rock and a Hard Place - Ethics 101 for Estate Planners; Estate Planner's Roadmap to Conflicts of Interest**
- **"Ready or Not, Here It Comes": The Hire Act, FATCA and the New Voluntary Disclosure Initiative**
- **Estate & Gift Tax Update: The Party's Over in 2013**
- **GRATS & CLATS: Does Anyone Want One? If So, Hurry**
- **Registered Domestic Partners & Same-Sex Married Couples Tax Update**
- **Federal and State Update: Personal and Estate & Gift Tax**
- **California's Taxation of Trusts: Compliance and Creativity**
- **Appraisals - How to Get and Defend a Good One**

Also, be sure to check out 'CLEtoGo' (on the same webpage) if you're interested in downloadable podcasts!

2012 CALENDAR OF EVENTS

Events Sponsored by the Taxation Section or State Bar

October 11 – 14, 2012: The 85th Annual Meeting of the State Bar of California
Monterey, CA
For more information, contact the Annual Meeting office at (415) 538-2210 or email Theresa Raglan at theresa.raglan@calbar.ca.gov or Carol Zlongst at carol.zlongst@calbar.ca.gov.

November 1 – 3, 2012: Annual Meeting of the California Tax Bar & the California Tax Policy Conference
Loews Coronado Bay Resort, San Diego, CA
For more information, contact Carol Zlongst at carol.zlongst@calbar.ca.gov or Annette Nellen at annette.nellen@sjsu.edu.

Upcoming Standing Committee Meetings

For more information on these meetings, please contact one of the officers of the relevant committee (please refer to the Taxation Section Leadership Directory, *supra*).

Compensation and Benefits Committee: For more information regarding upcoming meetings and events, please contact Committee Chair, Jeremy M. Pelphrey, at jmpelphrey@pensionlawyers.com or Committee Chair-Elect, Yana S. Johnson, at yjohnson@mofo.com.

Corporate and Pass-Through Entities Committee: The Committee holds quarterly meetings via teleconference. The next meeting will take place on Friday, September 28, 2012 from 12:00 p.m. to 1:00 p.m. Please contact Committee Chair, Haleh Naimi, at hnaimi@advocatesolutions.com for more information regarding upcoming meetings and events.

Estate and Gift Tax Committee: The Committee plans to hold its next meeting at the end of August. For more information regarding the Committee's upcoming August meeting and future events, please contact Committee Chair, Robin L. Klomparens, at rklomparens@wkblaw.com.

Income and Other Taxes Committee: The Committee generally holds quarterly meetings via teleconference. The next committee meeting, however, will take place in person on November 2, 2012 during lunch at the Annual Meeting of the Tax Bar held in San Diego. At the luncheon, the Committee will discuss its goals for the upcoming fiscal year including the submission of papers for the 2013 Washington Delegation and planning for the 2013 Annual Income Tax Seminar. Please contact Committee Chair, Eric Swenson, at eric.swenson@procopio.com for more information regarding upcoming meetings and events, including call-in number.

International Tax Committee: The Committee holds quarterly meetings via teleconference. The next meeting will take place on September 15, 2012 from 12:00 p.m. to 1:30 p.m. Dial-in information and agenda will be circulated to members prior to the meeting. For more information regarding upcoming meetings and events, please contact Committee Chair, Thomas M. Giordano-Lascari, at tmg@wrjassoc.com.

State and Local Tax Committee: The Committee plans to host its annual meeting at the Franchise Tax Board's Central Office in Sacramento on the same date as the regulation hearing for Proposed Regulation 25136.5-1. Please contact Committee Chair, Valerie Dickerson, at vdickerson@deloitte.com if you would like to receive an email announcement when the annual meeting details are finalized or if you would like to receive information regarding upcoming meetings and events.

CALENDAR OF EVENTS

Tax Exempt Organizations Committee: The TEO Committee holds occasional phone meetings, in addition to regular joint meetings with the Business Law Section Nonprofit Organizations Committee. The next phone meeting will be held on September 20, 2012 at 3:00 p.m. to discuss the IRS's recent announcement regarding the deductibility of donations to disregarded entities. The next in-person meeting of the Committee will be held on November 30, 2012 at the Los Angeles Marriott Downtown at 1:00 p.m. This meeting is held in conjunction with the Loyola Law School and IRS sponsored Western Conference on Tax Exempt Organizations. For more information, please contact the current chair of the TEO Committee, Patrick Sternal, at patrick@runquist.com or (818) 609-7761.

Tax Policy, Practice and Legislation Committee: On-line interaction is now available via the Committee's Yahoo Group: http://groups.yahoo.com/group/calbar_taxpolicy/. For more information, please contact Committee Chair, Cynthia Catalino, at ccatalino@catalinolaw.com or Annette Nellen at annette.nellen@sjsu.edu.

Tax Procedure and Litigation Committee: The Tax Procedure and Litigation Committee holds quarterly meetings. The next meeting of the Committee will be September 7, 2012 in San Francisco, at the offices of Winston & Strawn LLP. We plan to host a panel discussion on preparer, promoter and material advisor enforcement. For more information, please contact Committee Chair, Michel Stein, at stein@taxlitigator.com.

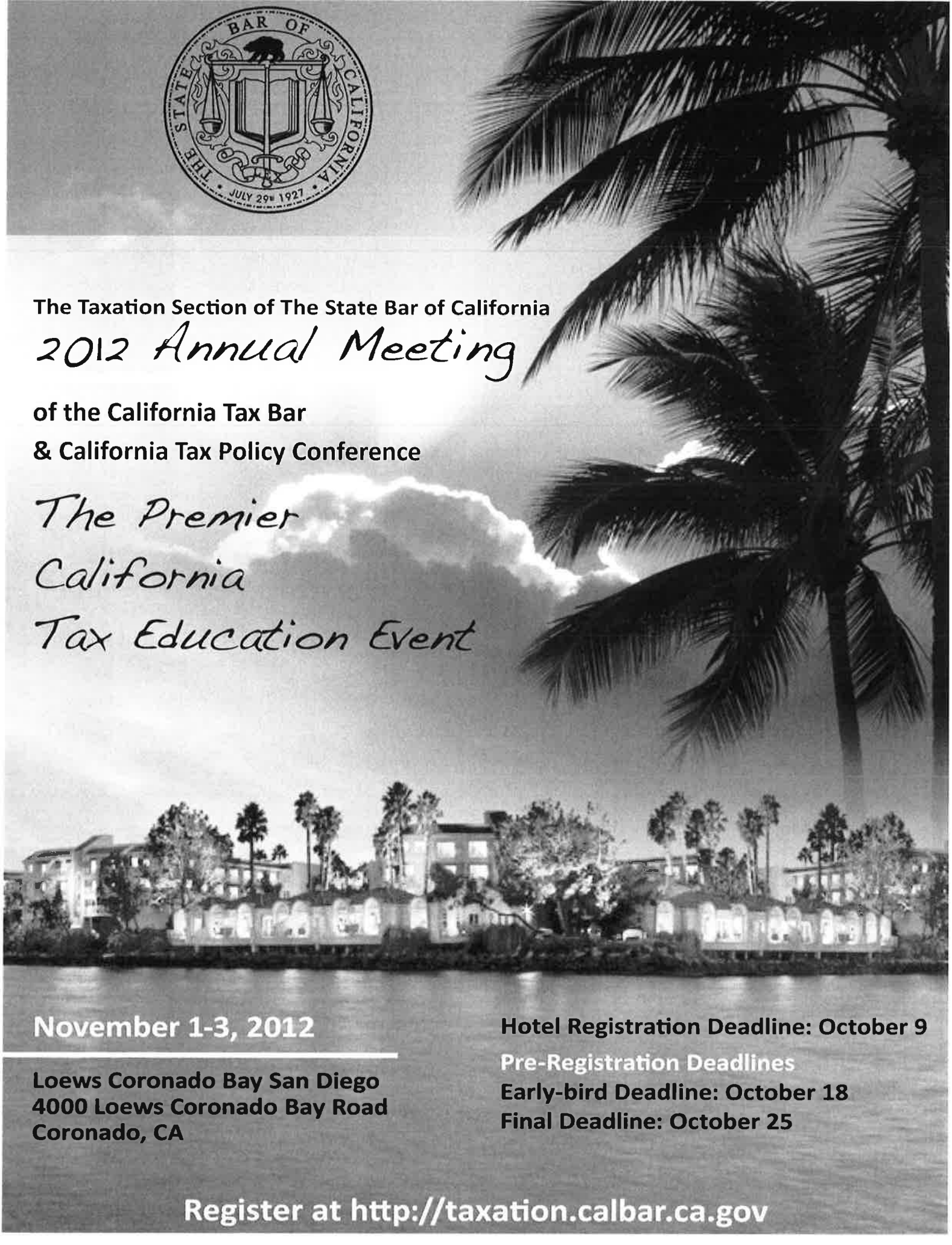
Young Tax Lawyers Committee Los Angeles Chapter: The Chapter holds monthly breakfast meetings. For more information, please contact Autumn Ronda at ar@vrmlaw.com.

Young Tax Lawyers Committee Sacramento Chapter: Chapter meetings are generally held every third Thursday of every other month in Sacramento. For more information regarding upcoming meetings and events, please contact Shellie Hughes at Shellie.hughes@boe.ca.gov.

Young Tax Lawyers Committee San Diego Chapter: Chapter meetings are generally held at 7:45 a.m. on the third Tuesday of each month in the Faculty Reading Room at the University of San Diego School of Law. For more information regarding upcoming meetings and events, please contact Kevan P. McLaughlin at kevan@mclaughlinlegal.com, or Alexandra Eaker at alexandra@irstaxdisputes.com.

Young Tax Lawyers Committee San Francisco Bay Area Chapter: For more information regarding upcoming meetings and events, please contact Sean Kenney and Dina B. Segal at BayAreaYTL@gmail.com.

Young Tax Lawyers Committee Silicon Valley Chapter: For more information regarding upcoming meetings and events, please contact Julie Y. Wann at julie@wannlaw.com or Michael Varela at mvarela@hopkinscarley.com.



The Taxation Section of The State Bar of California

2012 Annual Meeting

of the California Tax Bar
& California Tax Policy Conference

The Premier California Tax Education Event

November 1-3, 2012

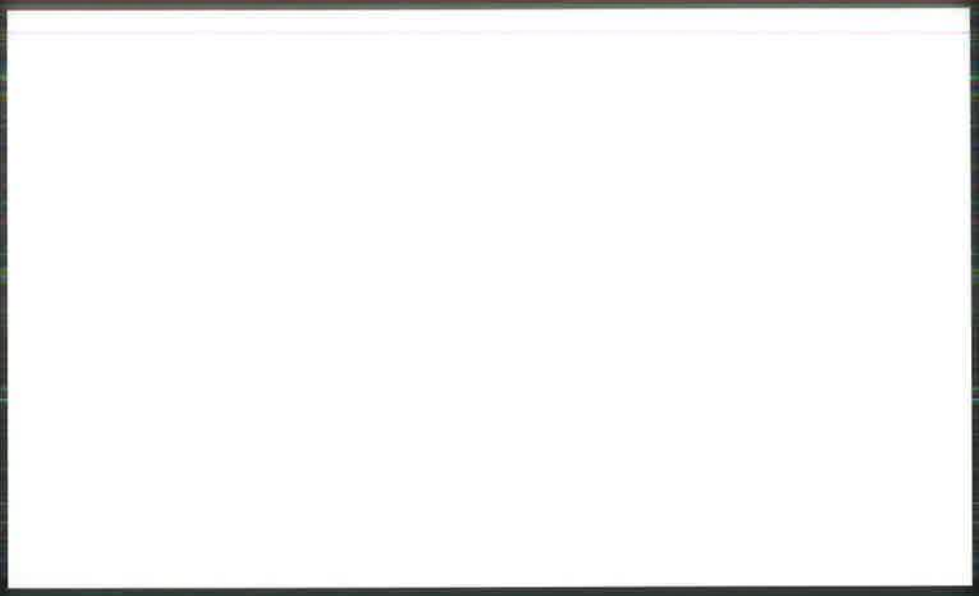
Loews Coronado Bay San Diego
4000 Loews Coronado Bay Road
Coronado, CA

Hotel Registration Deadline: October 9

Pre-Registration Deadlines
Early-bird Deadline: October 18
Final Deadline: October 25

Register at http://taxation.calbar.ca.gov

California Tax Lawyer
The Taxation Section
The State Bar of California
180 Howard Street
San Francisco, CA 94105-1639



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