Uncertainty Rules the Day - Supreme Court Denies Cert in *Lanco* and *MBNA*

The Supreme Court denied the petitions for certiorari to review the decisions of the Supreme Court of West Virginia in *MBNA*¹ and the Supreme Court of New Jersey in *Lanco.*² The substantive nature of the state court decisions have been discussed in prior issues of the Pepper Tax Update, but an analysis of the ramifications of the denial of certiorari is in order.

Pepper Perspective

*Does this mean that economic nexus is the law of the land?*

The Supreme Court’s denial of certiorari should be taken at face value as a denial of certiorari – nothing more, nothing less. It merely means that the holding in *Quill* is the last holding of the Supreme Court on the issue of substantial nexus.³ It also means that, at least in West Virginia and New Jersey, the holding in *Quill* is limited to sales and use tax, and that each court’s decision is the law of the land in that state. The denial does not mean that economic nexus is necessarily acceptable under the Commerce Clause of the United States.

What’s next?

Uncertainty continues to rule the land. The Supreme Court continually has declined to address these nexus issues post- *Quill,* starting with the *Geoffrey* decision in 1993.⁴ Pursuant to the Commerce Clause, Congress can regulate interstate commerce. The classic example was the passage of P.L. 86-272 into law approximately 50 years ago, protecting solicitation of sales of tangible personal property from income tax.⁵ Indeed, Senators Charles Schumer (D-NY) and Mike Crapo (R-Idaho) have introduced a bill that would codify federal standards for the definition of a taxable presence in a state. It is interesting to note that the proposed legislation has bipartisan support, as demonstrated through the bill’s sponsors. The uncertainty of the state of the law combined with the aggressive positions of the states and the Multistate Tax Commission (MTC) may mean that industry lobbying efforts for a clear standard across the United States may pick up steam. On the other hand, out of a sense of political caution, Congress, subject to the whims of the electorate, may be less inclined to address what could be a politically unpopular issue.

Indubitably, the states may view the failure of the Supreme Court to grant certiorari as an opportunity to expand their attempts to impose taxes up to the limits that are imposed by *Quill.* It is likely that the states and the MTC will view this inaction as further justification to push the limits.
on other generally accepted limits on tax, such as factor presence nexus.

**What are the FIN 48 implications of this decision?**

On the face of it, the implications of these decisions for financial accounting purposes should be limited to those taxpayers doing business in New Jersey and West Virginia with facts similar to those faced by the taxpayers in the instant case. For example, a financial institution with the requisite amount of business in West Virginia clearly may no longer have a ‘more likely than not’ position for not filing a return in West Virginia under a theory that the MBNA decision is unconstitutional. In other situations, the FIN 48 nexus determination is dictated by the facts of the particular case and the analogous authority available from New Jersey and West Virginia, and as a result, taxpayers should consider the ramifications of these decisions in determining the proper application of FIN 48.

**What about other constitutional challenges?**

The failure of the Supreme Court to hear these cases does not necessarily mean that any other Constitutional challenges are without merit. For example, challenges to addback statutes nationwide, as well as the ‘throwout rule’ in New Jersey, present discrete Constitutional issues and the Supreme Court presumably would address these when they are ripe for certiorari.

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**Endnotes**


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**Pittsburgh Tax Practice Group Held Tax Workshop**

The Pittsburgh Tax Practice Group held a tax workshop on June 28, 2007 entitled, “Corporate Tax Workshop, Increased Enforcement -- How to Manage the New IRS.” Pepper Hamilton tax partners Chuck Potter and Ellen McElroy spoke along with tax associate Ben Hussa. Mary Richter from the accounting firm Schneider Downs also lent her experience to the panel. The moderator was Scott Rantovich, Senior Director, Tax, Allegheny Technologies Incorporated.

**New IRS Rules of Engagement – Industry Issue Focus**

Recently, the Large and Mid-Size Business Division (LMSB) of the IRS promulgated new rules of engagement for its examiners that complicate the existing procedure for examining large corporate tax returns. Driven by the LMSB’s Industry Issue Focus (IIF) strategy, the changes in procedure center on issue resolution within individual cases, focusing on issues that are deemed "high-risk tax issues." The LMSB has centralized its control over the resolution of these high-risk issues by vesting supervisory power over their resolution to an LMSB director or delegate, dubbed the “Issue Owner Executive,” bypassing the direct chain-of-command authority for issue resolution. LMSB indicates that the reason for the new program is to achieve greater consistency, currency, and integrity in its treatment of complex tax issues.

Originally, the LMSB divided its examination resources into five departments, each having jurisdiction to administer tax laws to a particular industry group. Through this organization scheme, the IRS purported to develop examiners with industry expertise who could examine businesses more effectively than examiners without industry focus. When nationwide administration of these industry departments became difficult, the IRS incorporated geographic areas into its jurisdictional organization. The geographically aligned chain-of-
command reduced the control of Industry Directors over “significant taxpayers, significant issues, and/or sub-industries within their respective industries.” Additionally, geographic alignment constrained examination teams with expertise in one industry from examining businesses in a different industry. Thus, local leaders routinely lacked the industry director’s knowledge and expertise to evaluate specialized industry issues.

In March, the IRS established IIF to reallocate control over important issues to LMSB officials with industry experience. Sidestepping the “line authority structure” also permitted LMSB to flexibly apply its limited resources. Control over cases will still be assigned geographically, but “identification, development and resolution” of sensitive issues within those cases will be supervised by the Issue Owner Executive.

In this new process, one Issue Owner Executive is assigned to one high-risk issue, and his or her supervisory authority over that issue extends to “all LMSB cases involving similarly situated taxpayers.”

Enumerated Tier I issues are as listed below:

- Section 118 abuse
- Section 162(f) Department of Justice Settlements
- Section 199 domestic production deduction
- Section 409A nonqualified deferred executive compensation
- Section 936 exit strategies
- abusive foreign tax credit generators
- backdated stock options
- foreign earnings repatriation
- international hybrid instrument transactions
- mixed service costs
- research and experimentation credit claims
- transfer of intangibles offshore/cost sharing
- tax shelter (distressed asset/debt)
- tax shelter (redemption bogus optional basis).

Issues that do not measure up to Tier I criteria, but nonetheless involve “potential[] . . . significant compliance risk[s]” and law that is only “fairly well established” will be treated as Tier II issues. Tier II issues are described as “Issues of Significant Compliance Risk.” Unlike Tier I issues, the Issue Owner Executive lacks absolute control over Tier II issue resolution; instead, the rules require that she consult with the chain-of-command authority, or the “Line Authority Executive,” to resolve the issue.

Issues that have been designated as Tier II are listed below:

- Section 43 enhanced oil-recovery credit
- Section 172(f) specific liability loss
- casualty loss (single identifiable property/capital versus repair)
- cost-sharing (stock-based compensation)
- deferred home construction contracts
- extraterritorial income exclusion effective date and transition rules
• gift cards (deferral of income)
• health care accounting issues (contractual allowance)
• interchange merchant discount fees
• nonperforming loans
• super completed contract method
• upfront fees, milestone payments, and royalties in the biotechnology and pharmaceutical industries.

Tier III issues are described as “Issues of Industry Importance.” Industry authorities, collaborating with examiners and specialists, have power to establish Tier III issues. The rules of engagement delegate all “decision making authority” over Tier III issues to the “Line Authority Industry Executive” and do not delegate any authority to the Issue Owner Executive. At present, no issues have been designated as Tier III issues.

By centralizing control over high-risk tax issues, the IRS hopes to achieve greater consistency in resolving these issues as they arise among similarly situated taxpayers. It is hoped that this issue-based approach will enable LMSB to be more flexible in applying its limited resources to tax examinations that require greater attention. It is expected that entrusting resolution authority for high-risk issues to industry directors, or those with industry expertise, will yield more thorough examinations. The IRS feels that greater involvement of industry experts ensures that LMSB is aware of and responsive to strategic issues as they arise in the global business environment.

Pepper Perspective

Over the last several years, the IRS has increased enforcement actions against tax strategies that are aggressive and abusive. The best example of these efforts is the IRS pursuit of abusive tax shelters. Now, it appears that the IRS is beginning to pursue aggressive but non-abusive tax strategies with targeted enforcement efforts. Current efforts show a sharp increase in the number of examinations performed (both corporate and individual) and a significant increase in revenues collected.

The introduction of IIF is one aspect of these increased enforcement efforts. This new program suggests that examinations will become increasingly contentious. Because examiners are required to raise and examine more issues (they must raise Tier I issues and are directed to consider Tier II issues) and because Issue Owner Executives’ approval is required to settle any Tier I issue, and Line Authority Executives must consult with Issue Owner Executives with respect to Tier II issues, taxpayers should anticipate increased time for examination resolution and additional complexity in reaching examination resolution.

Although there is no simple formula for minimizing this increased controversy, the Tier I and Tier II lists provide a roadmap of examination plans. As a result, companies are no longer left to question which issues will be raised in examination. In fact, companies can now anticipate the issues that will be examined.

More importantly, companies may even prepare a thoughtful strategy in anticipation of examination. In preparing a strategy to address increased controversy, it is important to consider all of the dispute resolution tools that the IRS has made available in recent years. For example, companies frequently find that participation in either the Pre-Filing Agreement program or Compliance Assurance Program prior to filing a return may reduce controversy. In the right circumstances, a private letter ruling or accounting method change may be filed to minimize controversy or to secure resolution through IRS National Office prior to the time that an examination issue arises. Once an issue has been identified and examined, the Fast Track Settlement program may speed issue resolution. Depending on the nature of the controversy, the issues involved, IRS National Office disposition on an issue, issues pending in the current cycle, and/or a company’s relationship with its IRS Examination Team, these alternative dispute mechanisms can be used to both effectively raise and minimize controversy. Each should be given careful consideration when facing controversy.

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Three of the most significant elements of recently issued final regulations under Section 409A of the Code concern stock rights. In each case, the final regulations expand the circumstances in which stock options and stock appreciation rights can avoid the rigid compliance regime (or the adverse tax consequences) of Section 409A.

**Stock Option Extensions**

Prior to the publication of proposed regulations under Section 409A, it was common for issuers to extend the post-termination exercise period of stock options beyond the 90-day “default” period specified by most plans, especially in connection with negotiated executive severances. The proposed regulations eliminated the ability to make such extensions, other than for very brief periods.

The final regulations are substantially more permissive in this regard. Effectively, the regulations restore the ability of issuers to extend the post-termination exercise period of stock options. Specifically, the post-termination exercise period of a stock option (or stock appreciation...
right) may be extended without adverse tax consequences, provided the extension does not cause the award to remain exercisable beyond its originally scheduled expiration date (or, if sooner, beyond the 10th anniversary of its original grant date).

This development is significant for both issuers and award holders and is likely to restore the prevalence of stock option extensions in executive severance packages.

“Service Recipient Stock” Issues

To avoid characterization as deferred compensation, proposed regulations under Section 409A required that the stock subject to stock options or stock appreciation rights be “service recipient stock.” The definition of “service recipient stock” contained in the proposed regulations presented practical difficulties for both public and private companies.

The final regulations take a more practical approach and provide that service recipient stock includes the stock of the optionee’s employer, as well as the stock of any parent corporation that controls 50 percent or more of the optionee's employer (and, similarly, any corporation that controls 50 percent or more the first parent corporation, and so forth). The 50 percent control requirement may be reduced to as little as 20 percent, provided there are legitimate business reasons to support the relaxation of the control standard.

The service recipient stock concept still excludes most varieties of preferred stock.

This change will be particularly important in the context of diversified conglomerates and joint ventures.

Valuation Issues

To avoid characterization as deferred compensation under Section 409A, conventional stock options and stock appreciation rights still must have an exercise price equal to or greater than the fair market value of the underlying shares on the date of grant.

Determining that fair market value remains a challenge for companies that are not publicly traded. As an alternative to independent appraisals, many early stage companies have relied on a regulatory safe-harbor for non-independent valuations performed by individuals qualified by significant knowledge, experience, education or training in the field of business valuation. For example, many issuers have relied on valuations developed by managers of the venture capital or private equity funds that are their lead investors.

Under the proposed regulations, a significant limit on the use of non-independent valuations was the requirement that, at the time the valuation was to be applied, a change in control or IPO of the issuer could not be reasonably anticipated within the next 12 months. The Treasury Department now has acknowledged that the pace of change for many early stage issuers is rapid, and that it may be difficult to foresee business transactions 12 months in advance. Accordingly, the final regulations provide that a non-independent valuation may be relied upon so long as a change in control is not anticipated within 90 days and an IPO is not anticipated within 180 days.

Pepper Perspective

The reduction in the “anticipated transaction” window is welcome and critical relief for many early stage issuers. However, because of valuation concerns under financial accounting rules, we believe the trend of private companies seeking independent appraisals will continue.

While these changes do not remove Section 409A as a major consideration in the design of stock options and stock appreciation rights, they narrow the principal issues and in doing so, accommodate a wider range of conventional commercial practice.

The final regulations do not extend the December 31, 2007, deadline for bringing existing arrangements into
Significantly, this transaction is not a “listed transaction” for federal reporting purposes. On June 18, the leadership of the Senate Finance Committee sent a letter to Treasury Secretary Henry Paulson admonishing him to determine whether transactions similar to the one identified by New York should be “listed transactions” for Federal Income Tax purposes. The Finance Committee wanted the IRS to impose penalties upon charitable organizations who engaged in such transactions, noting that the deductions deprived the Treasury of $271 million in tax revenue. In addition to punishing complicit charitable organizations, the Committee also wanted to punish taxpayers who benefited from the charitable deductions.

On June 20, with these events in the background, the IRS promulgated Notice 2007-57, its first listed transaction in several years. The transaction deals with shareholders of S Corporations reporting losses but not gains associated with the activities of a foreign entity acquired by the S Corporation during the tax year.

Recent Developments in Listed Transactions

June has been a relatively prolific month for the promulgation of state and federal “listed transactions.” There were three significant events: (1) New York’s promulgation of a listed transaction, (2) the Senate Finance Committee’s issuance of a letter to the Service demanding a formal evaluation of transactions similar to New York’s listed transaction, and (3) the IRS’s promulgation of its first listed transaction in several years.

On June 13, the New York Department of Taxation and Finance issued Technical Service Bureau Memorandum TSB-M-07(5)C, which classifies types of charitable deductions as listed transactions having a substantial risk of franchise and personal income tax avoidance. The Department hereafter will scrutinize charitable contributions to tax-exempt organizations of remainder interests in real property encumbered by long-term leases. The Department is concerned that interests in these assets, after the taxpayer has held the interest for more than one year, can be appraised at values exceeding the value at which the taxpayer acquired the interest. The Department will challenge charitable deductions taken as part of this transaction or transactions substantially similar to it on the following grounds:

- the appraisal method inappropriately inflates fair market value
- the business purpose behind the transaction is invalid
- the transaction does not have economic substance other than for obtaining tax benefits
- the tax treatment of the transaction is based upon an elevation of form over substance.

Compliance with Section 409A. If you have questions regarding how the final regulations under Section 409A impact your arrangements, please contact Pepper soon.

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The IRS states that it will challenge these transactions by asserting “one or a combination of arguments including, but not limited to, arguments under §§ 165, 269, 482, and 988.” The IRS also may contend that such transactions lack economic substance.

**Pepper Perspective**

This recent activity should alert all taxpayers that tax authorities have not reduced their interest in tax shelter enforcement. It is still a hot issue that taxpayers need to be aware of.

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