

### ARTICLES

## The Impact of Gossett v. Tractor Supply

### Is Summary Judgment Still Available in a Discrimination or Wrongful Discharge Case Filed Under Tennessee Law?

**By:**  
J. Chadwick  
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For years, employers have been able to get questionable discriminatory and retaliatory discharge claims dismissed prior to trial by filing a motion for summary judgment. In many of those cases summary judgment would be granted after the court analyzed the plaintiff's claims under a framework commonly referred to as the *McDonnell Douglas* framework. In the recent decision of *Gossett v. Tractor Supply Company, Inc.*, the Tennessee Supreme Court held that the McDonnell Douglas framework is no longer applicable in analyzing a motion for summary judgment in a common law retaliatory discharge case.

Gary Gossett worked for Tractor Supply as an Inventory Control Manager in the company's General Accounting Department. Mr. Gossett claimed that his supervisor instructed him to remove products from the company's inventory reserve. According to Mr. Gossett, taking this action would have artificially increased the quarterly earnings statement in violation of The Securities Exchange Act of 1934



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and other federal securities regulations. Mr. Gossett claimed that he refused to participate in this allegedly illegal activity and instead submitted an accurate inventory reserve analysis to his supervisor. Approximately one month later Tractor Supply fired Mr. Gossett as part of a workforce reduction.

Tractor Supply moved for summary judgment on Mr. Gossett's claim. The trial court granted summary judgment to Tractor Supply but the Court of Appeals reversed. The Tennessee Supreme Court then granted Tractor Supply's application for permission to appeal.

In affirming the Court of Appeals decision to reverse summary judgment, the Tennessee Supreme Court held that the *McDonnell Douglas* framework and the similar framework adopted by the Tennessee Supreme Court in the case of *Anderson v. Standard Register Co.*, could no longer be applied when analyzing a motion for summary judgment in a common law retaliatory discharge case. The court held that those frameworks are inconsistent with the summary judgment standard in Tennessee.

Under both *McDonnell Douglas* and *Anderson*, if the employee establishes a *prima facie* case of discrimination or retaliation the employer must then offer a legitimate, nondiscriminatory or, in a retaliation case, nonretaliatory reason for the discharge. Offering that reason shifts the burden to the employee to show that the employer's stated reason was a pretext for discrimination or retaliation.

Tennessee's summary judgment standard requires that the party moving for summary judgment either affirmatively negate an essential element of the nonmoving party's claim or show that the nonmoving party cannot prove an essential element of the claim at trial. To affirmatively negate an essential element of the nonmoving party's claim, the moving party must point to evidence that "tends to disprove a material factual allegation made by the nonmoving party." For a more detailed discussion about the summary judgment standard in Tennessee see Meghan Morgan's [Woolf Prints article](#).

In *Gossett*, the Court held that the *McDonnell Douglas* framework could not be applied in analyzing summary judgment because, under that framework, the employer could

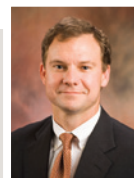
offer a legitimate reason for the employee's discharge without offering evidence tending to disprove any factual allegation by the employee. The Court further held that even though Tractor Supply had met its burden of production under *McDonnell Douglas* and *Anderson* by offering a workforce reduction as the reason for Mr. Gossett's discharge, this evidence did not meet the summary judgment burden of proving that a workforce reduction was the exclusive reason for Mr. Gossett's discharge. The Court also held that an employer could obtain summary judgment if it presents "undisputed" evidence that a legitimate reason was the "exclusive" motivation for discharging the employee.

In my experience, the cases where the employer will have undisputed evidence that a legitimate reason was the exclusive motivation for discharging the employee will likely be few and far between. This essentially means that the employee will have to agree that they were fired for a legitimate reason, such as poor attendance, and concede that they have no facts to show that they were fired for a retaliatory reason. Unless the employee and his or her attorney are "asleep at the switch" this is not likely to happen.

While *Gossett* involved only a common law retaliatory discharge claim, by implication the holding will apply to retaliatory discharge claims under the Tennessee Public Protection Act as well as discrimination and retaliation claims under the Tennessee Human Rights Act. From a practical standpoint, this means that when a discrimination or retaliation case is filed against an employer in Tennessee, it is unlikely that the case will be dismissed on summary judgment. As a result, employers will need to evaluate these cases early to determine whether the case should go to trial or should be settled before significant attorney's fees and expenses are incurred.



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# Codification of the Economic Substance Doctrine

By:  
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In March 2010, Congress passed the Health Care and Education Reconciliation Act of 2010.<sup>1</sup> The ostensible purpose of this legislation was to provide new laws regarding Medicare, Medicaid, reducing fraud, waste and abuse and provisions relating to tax on pharmaceuticals, medical device manufacturers and health insurance providers. Unfortunately, it has become almost customary for Congress to insert seemingly unrelated provisions in such legislation. Frequently, it may be questioned whether all of the Senators and Congressmen voting on such a bill even know of such insertions. This legislation was no exception.

In Section 1409 of the Health Care Act, Congress codified the Economic Substance Doctrine by adding Section 7701(o) to the Internal Revenue Code (the “Code”). Under the newly codified standard, all business transactions and activities engaged in for the production of income must meaningfully change the taxpayer’s economic position and the taxpayer must have a substantial nonfederal income tax purpose for the transaction. The IRS is also allowed to impose new strict liability penalties up to forty percent (40%) for transactions that lack economic substance. IRC § 6662(b)(6).

The obvious question is how to distinguish what types of transactions will meet the Economic Substance Doctrine and which transactions will not. Traditionally, there have been a number of acceptable tax-advantaged transactions. Tax credits, accelerated depreciation provisions and other Code sections deliberately encourage taxpayers to enter into transactions that they otherwise might avoid. Other Code provisions have the same affect, even if there is not clear evidence of Congressional purpose. For example, interest payments on debt are deductible, while dividends are not deductible. Therefore, Section 163 of the Code generally encourages corporations to incur debt rather than increase equity. A corporate taxpayer may choose to invest in a foreign country, so as to generate foreign-source income to use up existing foreign tax credit carry-forwards. Next year, dividends will be taxed at a higher



rate than capital gains. Thus, a closely held corporation that redeems outstanding shares for cash might struggle to satisfy a challenge by the IRS that there was a non-tax reason for the share buy-back as opposed to making a dividend distribution taxable at a higher rate.

In addition to Code-based transactions, there are many regulations and rulings that bless transactions where tax benefits drive the economics. Some of the best examples can be found among the elective entity regulations. There are very clear reasons for electing a partnership, an LLC or a corporation based upon tax considerations. Other such transactions include tax-driven sale-leasebacks.

In addition to Code or regulatory-based transactions, courts have held in favor of a taxpayer on many tax-advantaged transactions. In *John Kelley Co.*, a classic debt-equity case, the Court of Appeals called the transaction at issue “a matter of accounting hocus-pocus, guided by a little too clever legal planning which eventuated in a rather flimsy scheme to avoid paying of taxes.” *Commissioner v. John Kelley Co.*, 146 F.2d 466, 468 (7th Cir. 1944). But the Supreme Court reversed, holding for the taxpayer. 326 U.S. 521 (1946). Courts, in the past, have upheld a number of tax-advantaged transactions which the IRS had disputed.



The major question is whether codification of the Economic Substance Doctrine can be deemed to change the result of prior cases, prior rulings by the IRS or even prior Regulations. The real problem is that the new law now establishes a strict liability penalty of up to 40% if a taxpayer enters into a transaction which is later ruled to be in violation of the codified Economic Substance Doctrine. A legitimate question is whether the new uniform standard effectively overrules prior cases. For example, under existing common law, purely tax-motivated interest deductions have economic substance if the taxpayer incurred the challenged debt to engage in a “purposeful activity.” *Goldstein v. Commissioner*, 364 F.2d 734, 741 (2nd Cir. 1966). Is that test now replaced by the new codified standard? That is just one in a long line of cases where courts have based their decision on the substance, rather than the form, of the challenged transaction. The new Section 6662(b) (6) strict liability penalty provision applies to “any disallowance of claimed tax benefits by reason of a transaction lacking economic substance . . . or failing to meet the requirements of any similar rule of law.”

In conclusion, we will not know how broadly the Service will assert the Economic Substance Doctrine and its strict liability penalty for some time. It will probably be years before there have been enough real cases on this issue to know. Taxpayers will need to increase their efforts to place a transaction in its business context and the Service will no doubt look closely at technical tax planning and transactions which are frequently complex. As always, higher penalties raise the stakes.



<sup>1</sup> Pub.L. No. 111-152, 124 Stat. 1029 (the “Health Care Act”).

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## Highlights of the Small Business Jobs Act of 2010

**By:**  
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On September 27, 2010, President Obama signed the Small Business Jobs Act of 2010 (the “Act”) into law. The purpose of the Act is to stimulate the economy by encouraging investment in small businesses and allowing small businesses to hire more individuals and/or to invest more of their money in new materials or equipment. The means to that desired end include various tax breaks for small businesses and owners of small business stock. The more commonly-encountered of such tax breaks will be discussed in this Article.

### **Expanded Section 179 Expensing**

Generally, taxpayers can elect to deduct the cost of any “Section 179 property” in the year in which the property is placed in service rather than depreciating such property over time. Prior to the Act, “Section 179 property” meant any depreciable tangible personal property purchased for use in the active conduct of a trade or business, including “off the shelf” (i.e., not custom-designed) computer software placed in service prior to 2011. Also prior to the Act, the maximum deductible expense each year was \$250,000; and that deduction limit was phased out dollar-for-dollar to the extent the total cost of Section 179 property placed in service during the year exceeded \$800,000. For example, if a business purchased \$900,000 of depreciable tangible personal property during the year, it could deduct only \$150,000 (\$250,000 deduction limit, less the amount by which the total cost of such property purchased during the year exceeds \$800,000) with respect to such property. Those limits were in effect for tax years beginning in 2008 through 2010. For tax years beginning after 2010, the deduction limitation was to be only \$25,000; and the deduction was to phase out to the extent the total amount of Section 179 property purchased during the year exceeded \$200,000.

Under the Act, for tax years beginning in 2010 or 2011, a taxpayer can deduct the cost of Section 179 property placed into service during the year up to a maximum amount of \$500,000; and that deduction begins to be phased out dollar-for-



dollar only when the total cost of Section 179 property placed into service during the year exceeds \$2,000,000. Further, off-the-shelf computer software still qualifies as Section 179 property if it is placed in service before 2012. Additionally, the Act expands the definition of Section 179 property to include “qualified real property,” which includes certain leasehold improvements, certain restaurant fixtures, and certain retail store fixtures. In spite of the expanded definition of Section 179 property, the deduction with respect to qualified real property is limited to \$250,000 per year. The taxpayer may, however, still deduct an additional \$250,000 of tangible personal property under the total \$500,000 limitation.

For tax years beginning in 2012 or later, the maximum deduction amount reverts back to \$25,000, with a dollar-for-



dollar phase-out beginning when the cost of total Section 179 property placed into service during the year exceeds \$200,000. Further, real property will no longer be eligible for Section 179 expensing.

The increased expensing limits and expanded definition of Section 179 property in the Act are designed to encourage taxpayers to invest in Section 179 property in the next two years, as the deduction limits will dramatically decrease after that time. Taxpayers should be mindful, however, that Section 179 expensing is limited not only by the deduction limits discussed above but also by the aggregate amount of taxable income from any of the taxpayer's trades or businesses. Thus, if purchasing and expensing a large amount of Section 179 property in tax year 2010 or 2011 (especially qualified real property, the cost of which could be significant) would cause the taxpayer's deduction to be phased out or limited due to its overall taxable income, the taxpayer may be better served to spread the purchase of such property over a few years in spite of the lesser deduction amounts expected in the future.

#### **Extension of 50% Bonus Depreciation and AMT Depreciation Relief**

Under Section 168(k), a taxpayer is allowed to deduct 50% of the cost of "qualified property" as depreciation ("bonus depreciation") with respect to such property in the year in which it is placed in service; and qualified property is exempt from the AMT depreciation adjustment, which requires that certain property depreciated on a 200% declining balance method for regular income tax purposes must be depreciated on the 150% declining balance method for AMT purposes. "Qualified property" includes most machinery, equipment, and other tangible personal property; most computer software; and certain leasehold improvements, the original use of which begins with the taxpayer after December 31, 2007 and (under pre-Act law) before January 1, 2010. The Act changes the "placed in service" requirement so that property placed in service before January 1, 2011 can still be "qualified property" for this purpose, thereby extending the amount of time during which a taxpayer can purchase and place into service property qualifying for Section 168(k) bonus depreciation and encouraging taxpayers to purchase such property during 2010 if they have not already done so.

#### **Extension of Increase in First-Year Depreciation Limit for Passenger Automobiles**

Section 280F(a) imposes limits on the depreciation deductions (including Section 179 expensing deductions) that can be claimed with respect to passenger automobiles. Generally, for passenger automobiles placed in service during 2010, the first-year limit is \$3,060 (or \$3,160 for those automobiles built on a truck chassis). Prior to the Act, taxpayers placing passenger automobiles into service before December 31, 2009 could enjoy an additional \$8,000 of depreciation deductions if the automobile is "qualified property" under Section 168(k) (discussed above) and if the taxpayer did not elect to forego the 50% bonus depreciation and AMT depreciation relief otherwise available under Section 168(k). The Act extends the "placed-in-service" deadline so that taxpayers who place such passenger automobiles in service during 2010 can still take advantage of the \$8,000 in additional depreciation deductions with respect to such automobiles.

#### **Expansion of Start-Up Expenses Deduction**

Under Section 195(b)(1)(A)(ii), a taxpayer may elect to deduct up to \$5,000 in business start-up expenses in the tax year in which the taxpayer's active trade or business begins. The \$5,000 limitation is reduced dollar-for-dollar by the amount by which the taxpayer's total start-up expenses exceed \$50,000. Remaining start-up expenses may be deducted ratably over 180 months starting with the month in which the business begins.

Start-up expenses include the expenses incurred to investigate the creation or acquisition of a business (e.g., analyzing the potential market for a new product), to actually create or acquire the business (e.g., filing fees and professional fees for company organizational documents), or to engage in a for-profit activity in anticipation of that activity becoming an active business. The start-up expense deduction rule necessarily provides more benefit to smaller businesses, which may be entitled to an immediate deduction of 100% of their start-up expenses, while larger businesses with larger start-up expenses will be required to deduct those expenses ratably.

The Act amends the Section 195 start-up expense deduction by increasing the deduction limit to \$10,000 and providing that the deduction begins to phase out when the taxpayer's total



expenses exceed \$60,000. Such increases, however, apply only to tax years beginning in 2010. For tax years beginning in 2011 and thereafter, the limitations will revert back to the \$5,000 and \$50,000 amounts. Taxpayers who are planning on starting a new business in the near future are, thus, encouraged to begin the business in 2010 instead of waiting until 2011 in order to take advantage of increased start-up expenditure deductions.

### **Increase in Gain Exclusion for Qualified Small Business Stock**

Prior to the Act, a noncorporate taxpayer could exclude a portion of gain realized on the sale or exchange of “qualified small business stock” that the taxpayer had held for more than five years. The excluded percentage was generally 50%, although it was 60% for gain attributable to stock in a small business located in certain “empowerment zones” and 75% for stock acquired after February 17, 2009 and before January 1, 2011. “Qualified small business stock” is stock acquired by the taxpayer at its original issue after August 10, 1993, in a C corporation having not more than \$50 Million in assets (including assets of other members of a controlled group of which the corporation is a member) at all times from August 10, 1993 until immediately after the stock issuance (taking into account amounts received in the issuance). Further, the Corporation must remain a C corporation and conduct an active business during substantially all of taxpayer’s holding period for the stock in order for the stock to qualify. The gain excludable by the taxpayer with respect to qualified small business stock in any one corporation is equal to the greater of (a) ten times the taxpayer’s basis in the stock; or (b) \$10 Million.



Prior to the Act, a portion of the gain excluded for regular income tax purposes was included in income for Alternative Minimum Tax (“AMT”) purposes. For stock dispositions occurring before January 1, 2011, the percentage of gain included in AMT income (the “preference percentage”) was 7%. For dispositions after December 31, 2010 of stock that was acquired after December 31, 2000, the preference percentage was 28%. For

dispositions after December 31, 2010 of stock that was acquired before January 1, 2001, the preference percentage was 42%.

The Act increases the percentage of gain that may be excluded on the sale or exchange of qualified small business stock acquired after September 27, 2010 and before January 1, 2011 to 100% in all cases (regardless of whether the small business is located within an empowerment zone). The Act further provides that no part of such excluded gain will be a preference item for AMT purposes, thus ensuring that the gain on the sale of such stock will be excluded for both regular income tax and AMT purposes.

Of course, in order for the gain to be excluded, the stock must be held for at least five years. Presumably the tax laws could change between the date on which the taxpayer acquires the stock in the last quarter of 2010 and the time the taxpayer sells the stock five years later; thus, it remains to be seen whether taxpayers investing in small businesses during 2010 will enjoy the benefit of this increase. Further, this provision may be less effective than intended at encouraging investments in small businesses due to the fact that the tax break applies only to investments in C corporations when most small businesses are formed as S corporations, partnerships, or limited liability companies.

### **Extension of Shortened S-Corp Built-In Gain Holding Period**

Generally, when a corporation originally formed as a C corporation elects to become an S corporation, the S corporation is taxed at the highest corporate tax rate on all “built-in gains” (the untaxed appreciation in the corporation’s property at the time of its conversion to S corporation status) if such property is sold within 10 years after the conversion. Without the built-in gains tax, a corporation could elect S corporation status immediately prior to a sale of its assets and avoid a corporate level tax on the sale. Thus, the built-in gains tax was enacted to prevent certain abuses of the S corporation tax scheme.

The 2009 Recovery Act shortened the built-in gain tax period to seven years for tax years beginning in 2009 and 2010. Thus, no built-in gains tax would be imposed on an S corporation’s sale of its assets in the 2009 or 2010 tax years



if the corporation had held the assets for seven years after converting to S corporation status.

The Act further shortens the built-in gains tax period for 2011. If an S corporation sells its assets during a tax year beginning in 2011, no built-in gains tax will be imposed if the corporation has held the assets for five years from the date of the corporation's conversion to S corporation status. S corporations that are currently contemplating selling assets may wish to wait until the 2011 tax year if they have not yet held the assets for seven years but have held them for more than five years. The ten-year built-in gains tax period will return in 2012.

#### **Loosening of Restrictions on Cell Phone Deductions**

Section 274(d) generally disallows deductions or credits for items of "listed property" unless the taxpayer substantiates the cost of buying such item, the amount of each business or investment use of the item versus personal use of the item, the date of each expenditure for or use of the item, and the business purpose for each expenditure for or use of the item. The reasoning behind such heightened requirements was that the "listed property" items were expensive luxury items used only by executives (e.g., automobiles) and that such luxury benefits were subject to abuse in the form of nondeductible personal use. Prior to the Act, "listed property" included cellular telephones and other similar telecommunications equipment (e.g., Blackberries and PDAs) because, when such rules were made in the late 1980s, cellular phones were considered a luxury item. Obviously, times have changed and cell phones are now a part of daily business activities at all levels. Today, cell phones are equivalent to the 1980s land-line phone that an employee sometimes used to make personal phone calls without tax consequence. Heightened substantiation was never required for an employer to deduct the expenses of a land-line telephone in an employee's office.

To reflect the changed status of cell phones, the Act removes cell phones and similar devices from the "listed property" category; thus, the heightened substantiation requirements no longer apply to those items. As a result, employers may deduct the cost of providing cell phones to their employees for employment-related business use without having to satisfy strict substantiation requirements. The employer need only

substantiate the cost of the item, as the employer must do for other types of business equipment.

#### **Health Insurance Costs Deductible for Self-Employment Purposes**

In recent years, a self-employed individual has been able to deduct the cost of health insurance for himself and his family when computing his income for income tax purposes. Prior to the Act, however, health insurance costs have not been deductible from a self-employed individual's income for purposes of determining "net earnings from self-employment," on which self-employment tax is computed. The Act allows self-employed individuals to also deduct their health insurance costs in computing their net earnings for self-employment tax purposes; however, such deduction is only allowed for the 2010 tax year.

#### **Conclusion**

The Act contains broad changes in the tax laws applicable to businesses, and it contains traps for the unwary in making some of its changes effective only for one or two specific tax years. If you have questions as to how the Act's provisions may apply to you or your business, please contact a member of our tax group for assistance.



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## Foreign Bank Accounts and Multinational Corporations: UBS Was Only the Beginning

By: J. Eric Butler

For tax practitioners, the past year held many watershed events from an international tax perspective. First and foremost, the IRS/UBS Agreement is back on track after the Swiss Parliament recently voted to approve the agreement clearing the way for UBS to relinquish client data to the IRS. In recent months, however, IRS Commissioner Douglas H. Shulman has used invitations to speak before groups of tax practitioners as an opportunity to signal even more aggressive international tax enforcement programs in the immediate future.

### Examinations of Multinational Corporations

In prepared remarks delivered on June 8, 2010, before the OECD (Organization for Economic Cooperation and Development), Commissioner Shulman explained the groundwork was being prepared for joint-country audits of multinational corporations. At the OECD meeting, the Commissioner stated:

[W]e are now working on developing a protocol for joint audits with other countries. And before I go any further, let me be clear on a critical distinction. A joint audit is not a simultaneous exam. Rather, it is a process where two or more countries join together to carry out a single audit of a company with cross-border activities. As we envision it, the joint audit will be more sensible and efficient for the participating business because the business will not have the burden of two exam teams conducting two audits, and it will make sure both countries receive the same information and presentations from the taxpayer. If fully realized, the joint audit could have the potential of both boosting international tax compliance and improving service. In theory, if all the parties were in the same room, two or more tax authorities would hear the same facts, agree on the issues more quickly, jointly characterize a transaction, and agree on a treatment. It could reduce taxpayer burden — especially for large multinational corporations that must face audits in multiple jurisdictions on the same set of transactions. For a big multinational company, juggling multiple audits now comes with the territory. But a joint

audit process may provide taxpayers with a timesaving and less resource intensive way to address the tax consequences of a transaction on a bilateral or even multilateral basis.

Commissioner Shulman concluded his remarks by stating the IRS is working to create a “how-to” guide to assist countries wishing to participate in a joint audit process. Utilizing a wealth of information received from taxpayers with UBS accounts who availed themselves of the IRS Voluntary Disclosure Program, Commissioner Shulman expressed a desire to execute on “a new window of opportunity for tax bodies to achieve significant long-term compliance gains in the campaign against individuals parking assets and income in offshore banks.”<sup>1</sup>

### Global Tax Enforcement

In a speech to the AICPA National Conference on Federal Taxation, Commissioner Shulman took the opportunity to unveil his vision for global initiatives aimed at closing the tax gap through enforcement mechanisms. Regarding IRS efforts to identify offshore accounts held by U.S. taxpayers, the Commissioner stated:

There’s compelling evidence that more and more Americans are part of the international investment pool. For example, in just six years, the Foreign Tax Credit dollars claimed against U.S. tax by individuals has more than doubled – from \$6 billion dollars in 2001 to \$15.4 billion in 2007. In the IRS’ case, we’re focused on international tax issues from two distinct angles. First, in the business context, how do we ensure that taxpayers do not use the international capital markets and tax code complexities to push tax planning beyond acceptable bounds? Second, how can we better ensure that U.S. taxpayers with overseas assets pay what they owe? Rooting out individuals hiding their money in foreign jurisdictions is very different from the IRS and Treasury creating ground rules for multinational corporations operating in a global environment. It’s no secret that multinational corporations engage in sophisticated tax planning and there are plenty of international tax strategies that are perfectly legal. However, we also recognize that some businesses use the complexity of the tax code and international capital markets to push the envelope too far. Now, for individuals



with overseas income and assets, it's straightforward. If you are a U.S. individual holding overseas assets, you must report and pay your taxes or we will be increasingly focused on finding you. A week or so ago, I announced that over 7,500 people came in under our special offshore voluntary compliance program that ended earlier this month. It's too early to say how much money will come in from this effort. However, I can tell you that account sizes ranged from just over \$10,000 to over \$100 million. As importantly, these taxpayers are now back in the U.S. tax system and will be paying taxes on their offshore income in the years to come. A key aspect of our future international offshore work will be mining the voluntary disclosure information from people who have come forward. We will be scouring this information to identify financial institutions, advisors, and others who promoted or otherwise helped U.S. taxpayers hide assets and income offshore and skirt their tax responsibilities at home. . . . Our future offshore efforts will also be focused on multiple points around the globe, including funds flowing out from Europe to Asia, Central America and the Caribbean. To this end, the IRS is opening international Criminal Investigation offices in several new locations around the world – in Beijing, Panama City and Sydney, in addition to existing offices, such as Hong Kong and Barbados. The new locations will put the IRS closer to key locations around the globe for international tax administration purposes.

Commissioner Shulman also referred to a newly created group within the IRS known as the Global High Wealth Exam Group, the latest addition to the Service's arsenal of compliance strategies:

The last topic I want to discuss with you is our recent formation of a Global High Wealth Industry group housed in our Large and Mid-Size Business operating division. While we are in the early stages of this work, this new unit will centralize and focus IRS compliance expertise involving high-wealth individuals and their related entities – which can often have an international component. Tax agencies around the world, including those in Japan, Germany, the UK, Canada and Australia, have also formed high wealth groups. Now, high wealth individuals are not your typical Form 1040 filers with a

W-2, some 1099 income, and maybe a Schedule C enclosed with their return. And you cannot assess compliance among the nation's wealthiest individuals by looking only at their 1040s. Their tax picture is much more complicated than this. For a variety of reasons – including valid business reasons – many high wealth individuals make use of sophisticated financial, business, and investment arrangements with complicated legal structures and tax consequences. Many of these arrangements are entirely above board. Others mask aggressive tax strategies. And let me give you a flavor of these complex financial arrangements. They may include trusts, real estate investments, royalty and licensing agreements, revenue-based or equity-sharing arrangements, private foundations, privately-held companies, and partnerships and other flow-through entities that require looking at the entire, and often huge, spectrum of transactions and entities. A single high wealth individual may have actual or beneficial ownership of numerous related entities, sometimes alone and sometimes along with other family members or business associates. And there are other tax considerations regarding high wealth individuals, including international sourcing of income and tax residency, and offshore structures and bank accounts, to name just a few. . . . So here's our game plan. Going forward, we will take a unified look at the entire web of business entities controlled by a high wealth individual, which will enable us to better assess the risk such arrangements pose to tax compliance and the integrity of our tax system. Our goal is to better understand the entire economic picture of the enterprise controlled by the wealthy individual and to assess the tax compliance of that overall enterprise. We cannot do this by continuing to approach each tax return in the enterprise as a single and separate entity. We must understand and analyze the entire picture. We have begun hiring some agents and specialists, such as flow-through specialists and international examiners, who will begin conducting examinations of high wealth individuals and their related enterprises. Among our first steps will be a small number of examinations of these high wealth individuals that will use this integrated, or enterprise, approach. What we learn from these initial enterprise examinations will help us define the scope of our future work and build compliance tools going forward. Over time we will grow the new



unit by adding examination agents and individuals with specialized skills and expertise, such as economists to identify economic trends, appraisal experts to advise on valuation issues, and technical advisors to provide industry or specialized tax expertise. We will also build new risk assessment techniques to identify high-income and high-wealth individuals and their related enterprises that should be reviewed holistically. Let me stress that just as our international initiatives touch upon and involve every IRS Business Operating Division, so does the Global High Wealth Industry initiative. Even though the program is housed in the Large and Mid-Size Business operation division, we will be dealing, for example, with private foundations and retirement plan assets which fall under Tax Exempt and Government Entities, and flow-through entities that are part of our Small Business/Self-Employed Division. We are talking about small businesses . . . medium-size businesses . . . large businesses . . . private companies . . . and very wealthy individuals who may have a myriad of holdings and sources of income beyond the obvious ones. There are income tax as well as estate and gift tax issues.<sup>2</sup>

#### Conclusion

U.S. citizens possessing foreign bank accounts clearly have garnered the full attention of the Internal Revenue Service as of late. Commissioner Shulman has unequivocally stated his intention to use enforcement against foreign account holders as a mechanism for closing the tax gap. By expanding its focus to other countries harboring undisclosed foreign accounts, the Service is putting taxpayers on notice that it is merely a matter of time before these foreign accounts will be discovered through the above initiatives. Taxpayers holding undisclosed foreign bank accounts would be well advised to seek counsel regarding disclosure of these accounts to the Service to avoid potential civil and criminal sanctions.

<sup>1</sup> Commissioner Shulman's full remarks can be accessed at <http://www.irs.gov/irs/article/0,,id=224121,00.html>.

<sup>2</sup> Commissioner Shulman's full remarks can be accessed at <http://www.irs.gov/irs/article/0,,id=215606,00.html>.

## IRS Mostly Unsuccessful in Recent Reasonable Compensation Case

By: Kevin N. Perkey



Closely-held business entities that pay shareholder-employees big salaries and bonuses are at risk for a challenge by the Internal Revenue Service or the state Department of Revenue that a portion of the pay is a nondeductible dividend rather than deductible compensation. Often, owners of closely-held business and their advisors will structure distributions as either compensation or dividends based on whichever approach results in the least aggregate amount of taxes. For most business entities, but especially C corporations, this means treating as much of the distribution as compensation as possible. The IRS has a history of pursuing unreasonable compensation cases.

For compensation paid to a shareholder-employee to be deductible, the amount paid must be reasonable. Reasonable compensation depends on the facts and circumstances of each case. There are a number of factors that the courts will consider for purposes of determining the reasonableness for compensation including the shareholder-employee's role in the company, salary comparisons with other companies, the character and condition of the company, potential conflicts of interest, and internal inconsistencies in compensation. In a recent case before the United States Tax Court, the IRS challenged salary of \$2,020,000 and \$2,058,000 in successive years when the company's EBITDA was \$508,500 and (\$120,500) and net income was \$140,700 and (\$474,000), respectively. Upon audit, the IRS only allowed compensation deduction of \$655,000 in the first year and \$660,000 in the second year. Ultimately, the Tax Court looked at the five



factors listed above and held that the entire \$2,020,000 paid in year one was deductible but only \$1,284,104 paid in year two was deductible.

This recent case illustrates the fact that the Internal Revenue Service still keeps a close eye on reasonable compensation issues. To improve the odds that compensation will be reasonable, the company shall keep records of the responsibilities of the shareholder-employees during each year, if possible, have disinterested board members approve compensation, be consistent in the payment of compensation, and consider obtaining an opinion from a compensation expert regarding the reasonableness of compensation.

*Multi-PAK Corp.*, T.C. Memo 2010-139

### **“Plain Writing” Is New Rule for the Federal Government**

*By: J. Eric Butler*

Henceforth, forthwith, and posthaste, the federal government must now use “plain writing” in public documents. On October 13, 2010, President Obama signed into law the Plain Writing Act of 2010 (H.R. 946). Under the new Act, all federal agencies (including the IRS) must, within 9 months after the Act was signed into law, designate one or more senior officials within such agency to oversee the implementation of the Act and begin training its employees in the art of “plain writing”. Each federal agency also must create and maintain a plain writing section on the agency’s website that informs the public on the agency’s efforts to comply with the Act and provides a mechanism for public input on the agency’s implementation of the Act.

No later than 1 year after the date of enactment, the Act requires each agency to begin using “plain writing” in every “covered document” that the agency issues or substantially revises. A “covered document” is defined as any document that “(i) is necessary for obtaining any Federal Government benefit or service or filing taxes; (ii) provides information about any Federal Government benefit or service; or (iii) explains to the public how to comply with a requirement the Federal Government administers or enforces.” Under the Act,

“plain writing” is defined as “writing that is clear, concise, well-organized, and follows other best practices appropriate to the subject or field and intended audience.” Each federal agency must provide annually in the plain writing section of its website a report on the agency’s compliance with the Act.

### **Tennessee Construction Law Update 2010**

*By: Meghan H. Morgan*

➤ Public Chapter No. 950 amends Tennessee Code Annotated § 62-6-101 et seq. and establishes a classification of licensed masonry contractors. The new law requires masonry contractors who enter into contracts where the masonry portion of the construction project exceeds \$100,000 to be licensed. In order to be licensed, the masonry contractor must take and pass the masonry examination. The new law also authorizes the state board of licensing contractors to charge a licensing fee to cover all costs associated with issuing a license. For the purposes of establishing a masonry exam the act took effect May 26, 2010. For the purpose of accepting applications and administering the examination, the act took effect September 1, 2010. For all other purposes the act is effective January 1, 2011.

➤ Public Chapter 1055, which is applied to any home improvement contracts entered into on or after July 1, 2010, punishes, as theft, certain actions, including: (1) failing to refund amounts paid under a contract for home improvement services within ten (10) days of either acceptance of a written request for a refund hand delivered or mailed certified mail, return receipt attached or the refusal of acceptance of certified mail sent to the last known address of the home improvement service provider by the residential owner if (i) no substantial portion of the contracted work has been performed at the time of the request, (ii) more than ninety (90) days has elapsed since the start date of the home improvement contract, and (iii) a copy of the written request for refund was sent by the owner to the consumer protection division of the office of the attorney general; and (2) deviating or disregarding plans or specifications in any material respect contained in the contract for home improvement services including, but



not limited to, the amount billed for home improvement services being substantially greater than set forth in the contract, the materials used in the project being of a substandard quality when the owner was charged for higher quality materials or the owner did not provide written consent for the home improvement contractor to deviate from or disregard plans or specifications and such deviation or disregard caused substantial damage to the residential owner's property. The law also requires that the board of licensing contractors post information on its website when the board disciplines a contractor or home improvement service provider.



- Public Chapter 749 amends Tennessee Code Annotated § 66-11-101 et seq. by adding a new section § 66-11-150. Tennessee Code Annotated § 66-11-150, as enacted, removes lien authorization for unlicensed residential or home improvement contractors if the work to be performed is performed in a jurisdiction which requires such persons to be licensed. The act took effect July 1, 2010 and applies to any liens filed for residential construction or home improvement services performed on or after July 1, 2010.
- Public Chapter 875 amends the Prompt Pay Act of 1991, Tennessee Code Annotated § 66-34 101 et seq. by adding that, in the event a party withholding the retained funds fails to deposit the funds into an escrow account as provided within such chapter, such party shall be responsible for paying the owner of the retained funds an additional three hundred dollars (\$300) per day for each and every day that such retained funds are not deposited into such escrow account. Additionally, Tennessee Code

Annotated § 66-34-104 adds a new subsection that states that failure to deposit the retained funds into an escrow account within seven (7) days receipt of written notice regarding such failure is a Class A misdemeanor. This act became effective on May 3, 2010.

- Public Chapter 755 amends Tennessee Code Annotated § 49-2-203 relative to construction management services. As enacted, it clarifies and reiterates current law concerning what duties may be performed by general contractors and by architects and engineers performing construction management agent or advisor services for the construction of school buildings or the additions to existing buildings. The act became law April 13, 2010 and took effect immediately.
- Public Chapter 801 amends Tennessee Code Annotated § 62-6-119 related to bid documents. As enacted, the revised statute changes the requirements that must be contained on the outside of an envelope containing bid information to also require such information be included in an electronic bid. The new act removes criminal penalties for noncompliance and instead substitutes civil penalties of up to \$5,000 per day.

## **New Information Reporting Requirements for Businesses**

*By: J. Eric Butler*

In its present form, Section 6041 of the Code provides that every person engaged in a trade or business must file an information return with the Internal Revenue Service to report the payment of \$600 or more during any taxable year to another person for "rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income." The information returns filed by businesses under Section 6041 enable the IRS to match payments to certain payees to ensure proper reporting of income. The Regulations under Section 6041 presently provide that no information return is due for payments made to a corporation unless the payments are made in connection with medical or legal services.<sup>1</sup>



The Patient Protection and Affordable Care Act of 2010 (the “2010 Health Care Act”), signed into law by President Obama on March 23, 2010, contained many changes to the Internal Revenue Code unrelated to the field of health care. One such change involved amendments to Section 6041 of the Code to broaden the obligations of businesses to file information returns with the Service. Specifically, the 2010 Health Care Act amended Section 6041 of the Code to require that, beginning January 1, 2012, all persons engaged in a trade or business making payments of \$600 or more during any taxable year to another person for “rent, salaries, wages, *amounts in consideration of property*, premiums, annuities, compensations, remunerations, emoluments, *or other gross proceeds*, fixed or determinable gains, profits, and income” shall file an information return with the Service. (emphasis added). Thus, beginning in tax year 2012, Section 6041 will impose two additional categories of payments that trigger a reporting requirement for businesses.

The IRS has not promulgated Regulations to define the parameters of these two new categories under Section 6041 of the Code, and the statute itself does not provide definitions outlining the payments that will fall within the purview of these new categories. What may appear to be a small change, however, could significantly affect the number of Forms 1099-MISC a business must file with the IRS. It seems

payments for office supplies, equipment, furniture, fixtures, parts and materials in excess of \$600 — all of which are currently excluded from reporting — will trigger the new reporting requirement. For years, the IRS has been focusing on combating the unreported income that flows through the “cash economy”. Congress apparently wanted to ensure that payments made by persons engaged in a trade or business of \$600 or more in the aggregate in one tax year will be reported to IRS if made in 2012 or thereafter. These new information returns

purportedly will flag the payment for the IRS and assist the Service with determining if the payment was properly reported by the payee.

In addition to adding two new categories of payment triggering a requirement to file an information return, the 2010 Health Care Act also made other significant changes to Section 6041 of the Code. Where not otherwise provided in the Code, a “person” is defined under Code Section 7701(a) (1) as including a corporation. Under pre-2010 Health Care Act law, Section 6041 did not provide a definition of “person”; therefore, but for the explicit exception for payments to a corporation of \$600 or more contained in the Regulations (discussed above), information reporting would have been required for payments to a corporation.

The 2010 Health Care Act provides in Section 6041(i) of the Code that, notwithstanding any Regulation issued by the IRS before March 23, 2010, the term “person” includes “any corporation that is not an organization exempt from tax under section 501(a).” Thus, a business will be required to file an information return for all payments aggregating \$600 or more in a calendar year to a single payee, other than a payee that is a tax-exempt corporation. Congress apparently wants to ensure that payments made by persons engaged in a trade or business to a corporation, other than a tax-exempt corporation, of \$600 or more in the aggregate in one tax year will be reported to IRS if made in 2012 or thereafter.

Under the 2010 Health Care Act, Section 6041(j) of the Code permits the IRS to prescribe Regulations and other guidance as may be appropriate or necessary to carry out the purposes of the information reporting rules, including rules to prevent duplicative reporting of transactions. To date, the IRS has not published any notice of proposed Regulations to instruct business owners on the new reporting requirements. Thus, it is unclear whether the IRS will require payors to use the current Form 1099-MISC for these two new payment categories or whether a new form will be implemented to monitor such payments.

While the reporting requirements under Section 6041 are undergoing major changes, the penalties for failing to file required information returns also have been modified by Congress. In the Small Business Jobs Act of 2010, signed by





President Obama on September 27, 2010, Congress increased the penalties for the failure to file a required information return under Section 6041 of the Code. Effective January 1, 2011, the penalty for failure to file a required information return will be increased from \$50 to \$100 for each occurrence, with the annual maximum penalty per taxpayer increasing from \$250,000 to \$1.5 million. Similarly, the penalty for failing to timely provide a correct payee statement generally increases from \$50 to \$100, with the annual maximum penalty increasing from \$100,000 to \$1.5 million. In addition, both the failure to file and the failure to furnish penalties will adjust to account for inflation every five years with the first adjustment to occur after 2012.

Not only will businesses be required to report payments made for goods and services totaling \$600 or more, but they also will be required to obtain a taxpayer identification number (TIN) from each vendor to whom a reportable payment is made. The failure to obtain a vendor's TIN can cause reportable payments to be subject to backup withholding. To minimize the risk of filing a Form 1099 with an incorrect TIN or name, a business should consider utilizing the Service's TIN matching program.<sup>2</sup> As a program participant, a business can check the TIN furnished by a vendor against the name/TIN combination in the IRS database well before the business may be required to file information returns. This process should help a business avoid potential information return penalties, as well as minimize the risk of a backup withholding requirement.

On November 12, 2010, Senate Finance Committee Chairman Max Baucus (D-Mont.) issued a news release<sup>3</sup> stating he intended to introduce legislation to repeal the requirement for businesses to file Forms 1099 for payments made for good and services under the 2010 Health Care Act. Apparently many small business owners made known to the Chairman their disagreement with the new legislation, as the news release noted: "[F]ollowing passage of the law, some business owners expressed concern that when the provision does go into effect, the forms would place too large of a paperwork burden on businesses struggling in a still-recovering economy." Chairman Baucus responded that he received the message "loud and clear" and that small business owners "need to focus their efforts on creating good-paying jobs" rather than filling out paperwork.

Assuming the new legislation remains effective for 2012, businesses clearly will have to modify their accounts payable systems to comply with the expansion of the information reporting requirement under Section 6041 of the Code. In her most recent report to Congress, the Taxpayer Advocate noted that an analysis of 2009 IRS data revealed that approximately 40 million businesses and other entities will be subject to the new reporting requirement, including roughly 26 million non-farm sole proprietorships, 4 million S corporations, 2 million C corporations, 3 million partnerships, 2 million farming businesses, 1 million charities and other tax-exempt organizations, and more than 100,000 government entities.<sup>4</sup> According to a report issued by the Joint Committee on Taxation, the new reporting requirement under Section 6041 of the Code was scored to raise \$17.1 billion from 2012 to 2019.<sup>5</sup>

The influx of Forms 1099-MISC for payments under the two new categories in Section 6041 undoubtedly will be used by the IRS as a tool to combat what it perceives as the underreporting of income by small to mid-size businesses. The new information returns also could assist the IRS in the audit selection process. Businesses and organizations that prepare now for the expanded reporting requirements that take effect on January 1, 2012, will be better positioned to avoid the many problems that can result from information reporting failures.

<sup>1</sup> See Treas. Reg. § 1.6041-3(p)(1).

<sup>2</sup> See Rev. Proc. 2003-9, 2003-1 C.B. 516.

<sup>3</sup> See <http://finance.senate.gov/newsroom/chairman/release/?id=3f00ef74-7efd-40a8-8052-745270b70e34> (last visited November 15, 2010).

<sup>4</sup> See Taxpayer Advocate Service, National Taxpayer Advocate Report to Congress (June 30, 2010), Doc 2010-15078, 2010 TNT 130-15, at pp. 9-13.

<sup>5</sup> See JCX-17-10, Doc 2010-6144, 2010 TNT 55-22.



## FIRM SPOTLIGHT

- **Chad Hatmaker** has been selected as a member of the 2010-2011 Class of Leadership Children's by East Tennessee Children's Hospital (ETCH). Patterned after Leadership Knoxville, Leadership Children's enables rising community leaders to be more aware of the services ETCH offers.
- **Howard E. Jarvis** and **J. Ford Little** have been elected as Fellows of the Knoxville Bar Foundation. The Fellows program was instituted in 2001 and serves to help the Foundation in its fund-raising efforts and to provide a means to publicly recognize and honor attorneys who have distinguished themselves in the practice of law and in service to the Knoxville legal community.
- **Howard E. Jarvis** served as a judge for the annual Advocates Prize Competition at the University of Tennessee College of Law. Supreme Court Justice Clarence Thomas presided over the final round of the competition.
- **J. Ford Little** served on the University of Tennessee Presidential Search Advisory Committee which was involved in the selection of the new 24<sup>th</sup> president of the University of Tennessee, Joe DiPietro. The candidates were narrowed from a list of 71 applicants and the Presidential Search Committee nominated Brian Noland and DiPietro to the board for final consideration. DiPietro is the first candidate from within the University to be elected president since Joe Johnson, who was president from 1991 to 1999. He will take office in January, replacing Jan Simek, who has served as interim president since 2009.
- Twenty-seven Woolf McClane attorneys were selected by their peers to be listed as "Top Attorneys" in *Cityview Magazine*.



# Woolf Prints

East Tennessee Tax & Business Bulletin

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