LEGAL UPDATE

CLIENT NEWSLETTER OF
CARR, MORRIS & GRAEFF, P.C.

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CMG WELCOMES THOMAS BERGER

We are proud to announce that Thomas K. Berger has become "Of Counsel" to Carr, Morris & Graeff. Tom's practice concentrates predominantly on criminal and civil litigation. He has had considerable experience in handling cases before federal and state courts and administrative agencies, including the defense of individuals and companies accused of federal and state criminal conduct, the representation of pilots before the Federal Aviation Administration and the representation of trucking companies in their regulatory compliance. He has been awarded an *A-V* rating by Martindale-Hubbell, the highest rating awarded by that organization for competence and integrity.

Tom is admitted to the bars of Virginia, the District of Columbia and Mississippi. He has practiced law since 1974. From 1974-1986 he was an Assistant United States Attorney for the Eastern District of Virginia and was the First Assistant U.S. Attorney for the Eastern District of Virginia from 1981-1986. He has been in private practice in Northern Virginia since 1986 and brings both talent and depth to the firm's criminal, civil and regulatory capabilities.

Tom is a FAA-licensed pilot, and holds single-engine land, single-engine sea, multi-engine land, and instrument ratings. He also holds a 50-ton U.S. Merchant Marine Master's license.

TAX
TAX LOSS HARVESTING AND THE WASH-SALE RULE

Recent stock market movements have been decidedly in one direction; October was the worst month for the Standard & Poor's index of 500 stocks in 21 years — since the 1987 stock market crash. For those who hold their investment portfolio at least partly in taxable accounts, the recent downturn presents opportunities for year-end tax savings. (For those whose investment portfolio is comprised entirely of tax-deferred retirement accounts, the following will not apply.) I suspect that each of us holds a few losers in our stock portfolios – now may be the time to turn that paper loss into an actual loss and reap the tax savings.

We all know that we are allowed up to a $3,000 tax deduction for capital losses which can be carried over to subsequent tax years. Nevertheless, let's review some of the "netting" provisions applicable between short-term and long-term capital gains and capital losses. Your fist step is to add together all your gains and losses. First, you net your short-term gains and losses — that is, you calculate each individual gain or loss by subtracting the purchase price of the securities (including commissions) from sales proceeds net of commission. Then just sum everything up. You'll come up with an overall net short-term gain or loss figure. Next, you net your long-term gains and losses in the same fashion. You'll end up with either a net long-term loss or a net long-term gain. Combining your net long-term and short-term

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TAX
ESTATE TAXATION OF PUERTO RICO RESIDENTS

In previous issues of this publication, we have discussed U.S. income taxation of Puerto Rico residents. In this issue we tackle estate taxation of such residents. The island of Puerto Rico was acquired by the U.S. from Spain under the Treaty of Paris of 1898. Puerto Ricans have been U.S. citizens since 1917, but Puerto Rico is not a state. It is organized as a Commonwealth of the United States. As such it has no votes in the Electoral College and no representation in Congress. Puerto Ricans, though, are subject to conscription in the U.S. armed forces and travel as U.S. citizens with U.S. passports under the protection of the U.S. government. Puerto Rico's Commonwealth status has given rise to a complicated estate tax situation revolving mostly around the issue of domiciliary status in Puerto Rico.

U.S. citizens, resident aliens and domiciliaries are subject to estate tax on their worldwide estates with an exemption equal to the applicable exclusion amount for the year in question. Persons who are not U.S. citizens, resident aliens, or domiciliaries, known generally as nonresident aliens, are subject only to estate tax on their U.S.-situs assets, but are accorded only a $60,000 exemption. United States realty, and the stocks and bonds of U.S. companies, are typical U.S.-situs assets. Life insurance is not, nor are deposits in U.S. banks.

The general rule is a decedent will be considered a nonresident alien with respect to the U.S. if, at the time of death, decedent was domiciled in Puerto Rico and was a U.S. citizen who acquired his U.S. citizenship solely by reason of being a citizen of Puerto Rico or by reason of birth or residence within Puerto Rico. These somewhat cryptic definitions have been elucidated by Treasury regulations. The regulations give four examples:

- A, who acquired her U.S. citizenship under Section 5 of the Act of March 2, 1917, by reason of being a citizen of Puerto Rico, died there while domiciled there also. A was a nonresident alien.
- B, whose parents were U.S. citizens by virtue of their birth in Philadelphia, was born in Puerto Rico, where he died as a domiciliary of the island. B was a nonresident alien since he acquired his U.S. citizenship

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The articles in this publication are designed to give general information on the matters covered. Space limitations prevent exhaustive treatment or analysis of any topic. The articles are not intended to substitute for advice on specific legal problems.

PRODUCTS LIABILITY SUPREME COURT REVIEWS PREEMPTION DOCTRINE

On November 3, 2008, the United States Supreme Court heard oral argument in a case, *Wyeth v. Levine,* No. 06-1249 that is being closely watched by all within the business community. Briefly, the case involves a Vermont woman who was awarded judgment of approximately $6.8 million after suffering a severe adverse reaction to the drug Phenergan, manufactured by Wyeth. Ms. Levine received Phenergan by "IV-push" to treat migraine headaches; her adverse reaction resulted in the development of gangrene and ultimately led to amputation of her right arm below the elbow. In essence, the trial jury had found that the drug's label should have more specifically warned of the known dangers of injecting Phenergan directly into a patient's vein. Wyeth contended that it was immune from a state negligence lawsuit because the Food and Drug Administration ("FDA") had approved Phenergan's labeling and, as such, the state court action had been *preempted* by that FDA approval. The plaintiff, Diana Levine, age 63, is a professional musician who is now required to use a prosthetic limb while playing her guitar.

The case heard by the Supreme Court stemmed from a 2006 decision rendered by the Supreme Court of Vermont in *Levine vs. Wyeth,* reviewing the trial court's judgment against Wyeth. The fundamental ruling at issue was that injection of Wyeth's drug caused Levine's horrific injuries and that Wyeth was liable for its failure to adequately warn users of possible adverse effects. On appeal of the jury award, the Vermont Supreme Court held that the plaintiff's state law claim for failure to warn was *not preempted* by FDA regulations. Loosely defined, "preemption" is a doctrine that shields a manufacturer from state/common law tort claims if it can show its conduct satisfied applicable federal laws and regulations. For the most part business advocates and business groups strongly favor preemption, while consumer groups and state regulators oppose the doctrine as impeding the consumer's rights of redress.

Before the Supreme Court of Vermont, Wyeth argued that the trial court was wrong in allowing the jury to consider Ms. Levine's claims because those claims conflicted with Wyeth's obligations under federal law regulating prescription drug labels. Having satisfied FDA labeling regulations, Wyeth argued, it is immune from state law claims of this sort. The Vermont appellate court rejected Wyeth's argument, holding that there was no conflict between state and federal law that required preemption of plaintiff's claim. The Vermont appellate court noted that the trial court did instruct jurors that they could consider the FDA's approval of the label in use at the time of plaintiff's injury but that the label's FDA compliance did not establish the adequacy of the warning or prevent Wyeth from strengthening the warning. The Vermont Supreme Court stated, "We hold that the jury's verdict against Defendant did not conflict with the FDA's labeling requirements for Phenergan because Defendant could have warned against IV-push administration without prior FDA approval and because federal labeling requirements create a floor, not a ceiling, for state regulation."

The United States Supreme Court's decision to hear Wyeth's appeal of the Vermont Supreme Court's affirmation of the jury award is significant in that it may shed light on the preemption doctrine, which could either foster or impede the filing of similar cases throughout the pharmaceutical and business community and could involve literally billions of dollars in potential awards. The specific question presented to the Supreme Court in *Wyeth v. Levine* is as follows: "Whether the prescription drug labeling judgments imposed on manufacturers by the Food and Drug Administration ("FDA") pursuant to FDA's comprehensive safety and efficacy authority under the Federal Food, Drug and Cosmetic Act, 21 U.S.C. § 301 *et seq.*, preempt state law product liability claims premised on the theory that differing labeling judgments were necessary to make drugs reasonably safe for use."

Wyeth filed its Petition for a Writ of Certiorari on March 12, 2007. Wyeth's central contention for asking the Supreme Court to hear the case was that "Granting this Petition would enable the Court to resolve the pervasive and recurring conflict between state claims of power to regulate prescription drug labeling and the integrity of the congressionally mandated federal prescription drug labeling regime that lies at the heart of the Food and Drug Administration's regulatory authority." The Petition goes on to state, "This conflict is currently at issue in tens of thousands of cases in our nation's courts, in which Plaintiffs claim that manufacturers should have modified FDA-approved prescription drug labeling," and that, "A ruling by this Court on the preemption issues presented would provide invaluable guidance to the hundreds of federal and state judges now grappling with these claims."

In recent years the Bush administration, business groups and lobbying firms for businesses have advocated lawsuit limitation citing the doctrine of preemption, arguing that federal regulation be afforded primacy over contrary laws that may differ on a state-to-state basis. Based on questioning during the November 3, 2008 oral argument, it is unclear how the court will rule concerning preemption. Justice Scalia seemed most opposed to the decision of the Vermont Supreme Court, stating that, "Excuse me, the risks were set forth on the labeling." Continuing, he stated, "If you are telling me the FDA has acted irresponsibly, then sue the FDA. …" Justice Souter seemed more sympathetic to the reasoning of the Vermont Supreme Court when he stated, "Wyeth could have gone back to the FDA at any time and said, either based on experience or just rethinking of the data that we have, we think the label ought to be changed to say, 'Don't use IV push'." Justice Kennedy, often a swing vote, also seemed troubled by Wyeth's argument. Regardless of the outcome, the Supreme Court's decision in *Wyeth v. Levine* will certainly be a turning point in the national debate over the preemption doctrine.

STEPHEN GRAEFF

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solely by birth in Puerto Rico.

- C, a former French citizen, acquired citizenship in the U.S. through naturalization proceedings in a court located in Puerto Rico after having qualified for citizenship by residing in Puerto Rico for five years. C died in Puerto Rico being domiciled there. C was a nonresident alien since she acquired U.S. citizenship solely by residence in Puerto Rico.
- Finally, D, a citizen of the United States by reason of his birth in Chicago, established residence in Puerto Rico, acquired Puerto Rican citizenship, and died while a citizen and domiciliary of Puerto Rico. D is not a nonresident alien but rather is subject to estate tax as a U.S. citizen.

Since those persons who fall under the aforementioned definition of Puerto Rico domiciliary are nonresident aliens, they must take the same precautions in investing in U.S. assets as other nonresident aliens, especially because the exemption is a low $60,000. This means, when investing in U.S. realty or U.S. stock, they must do so through a foreign corporation. To make life easier for foreign investors Treasury regulations list the foreign entities considered *per se* foreign corporations. The Puerto Rico "*Corporación*" is among them. Because *bona fide* residents of Puerto Rico are taxed by the U.S. on their world-wide income (except for income from sources in Puerto Rico), Puerto Rico domiciliaries cannot avail themselves of the portfolio interest exemption, and thus the debt itself is U.S.-situs. For nonresident aliens not from Puerto Rico, the debt itself would not be U.S.-situs since its income would be excluded from U.S. income taxation.

In sum Puerto Rico domiciliaries need to be very careful when investing in U.S. assets. They must first ascertain whether they would be considered nonresident aliens under the rather complicated rules explained previously. Then they must examine each asset to determine situs, bearing in mind the rules for some assets will differ from the regular rules. A good rule of thumb in order to totally avoid U.S. estate taxation is to simply invest in the U.S. only through a Puerto Rico "*Corporación*."

One final tax policy note. Presently, the U.S. has zero household saving. We rely largely on nonresident aliens to provide capital for our economic growth. Congress, as a matter of national security, should not put unnecessary tax obstacles in the way of badly needed foreign investment, whether from Puerto Rico domiciliaries or other nonresident aliens. The estate and income tax rules applicable to nonresident aliens are of such mind-numbing complexity they only serve to discourage foreign investment, while raising no more revenue that a simpler scheme would. In any case, the rules should be designed to *attract maximum* investment regardless of their revenue-raising capability.

NÉSTOR CRUZ

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gains/losses can lead to any of several possible outcomes which you will want to review with your accountant or other tax professional. Given the recent market climate, though, it is likely that you will have both short-term losses and net long-term gains. Net long-term gains can be offset by short-term losses. If short-term loss exceeds long-term gain, the overall loss is considered short-term, which means you can deduct up to $3,000 against other income, and then carry over any excess to next year. If short term losses do not exceed net long-term gains, the difference is taxed at the preferential capital gains rate.

Tax loss *harvesting* is the art of using capital losses to offset capital gains for tax purposes. The idea is simple – to capitalize on your current paper losses by recognizing the loss now, and then, with the proceeds from the tax loss, buying other securities in this depressed market. A clear example: you bought 50 shares of XYZ Corporation in January at $100 per share (total investment of $5,000), you sell the 50 shares of XYZ Corporation in November at $40 per share (result is a short term loss of $3,000). You can claim a tax deduction of $3,000 on your taxable income for the year, or use it to offset a gain you have elsewhere in your portfolio by $3,000. After taking advantage of the tax savings, you can now invest the proceeds ($2,000) in another security – however, beware of the *Wash-Sale Rule*.

You cannot immediately re-invest the $2,000 proceeds from the sale back into XYZ Corporation – this is a violation of the Wash-Sale Rule and you will lose the tax benefit of the short-term capital loss. The Wash-Sale rule stipulates that a security is disallowed for a loss deduction if a ***substantially identical*** security is purchased within 30 days *before or after* the sale of the security used for the loss deduction. This rule was introduced to prevent the sale of securities just for avoiding taxes. The IRS does not have a clear definition of "substantially identical"; it is determined by all the facts and circumstances in a particular case. Two share classes of the same fund, such as a mutual fund and a corresponding ETF, are probably substantially identical. There is no ruling on whether two funds operated by different companies tracking the same index are substantially identical; tax experts have differing opinions. Two funds tracking different indexes, or an index fund and an actively managed fund in the same asset class, should not be substantially identical; again, there is no clear IRS ruling.

Therefore, when tax loss harvesting, if you do not hold proceeds of your sale for the 30-day waiting period, you will need to find another security which is not substantially identical (shares of one corporation cannot be substantially identical to those of another corporation; *e.g.*, Ford and GM, Coke and Pepsi).

While never enviable, if you are sitting on a large paper loss, look at the silver lining and consider recognizing the loss for tax purposes. Remember, your loss will be disallowed as a deduction, or an offset of other gains, if you invest the proceeds in a substantially identical security within 30 days before or after the sale. When discussing this tax loss harvesting strategy with your tax professional as part of year-end planning, also consider maximizing your tax-advantaged retirement accounts, performing Roth IRA conversions, 529 plan contributions for your children or grandchildren, estate planning and depleting your "use it or lose it" flexible spending accounts.

JUSTIN BANFORD

CARR, MORRIS & GRAEFF, P.C.

Carr, Morris & Graeff, P.C., was established in 1982 by the named principals–Lawrence Carr, Roy Morris and Stephen Graeff. It is a diversified firm structured primarily to meet the legal needs of businesses and their principals.

The firm strives to provide full service representation to its corporate and individual clients. It is designed to provide such service by organization and presentation of an array of attorneys with diverse backgrounds in specialized areas of the law as well as a generalized background which enables them to look beyond a narrow specialty or need. The academic and cultural backgrounds of the attorneys of the firm are as diverse as their experience and specializations.

Carr, Morris & Graeff, P.C., specializes in the following areas: Corporate/General Business; Taxation/Estate Planning; Civil/Commercial Litigation; Criminal Representation; Alternative Dispute Resolution; Employment/Labor; Discrimination; and Wage-Hour.

STAFF NOTES

Violating Rule #1. Due to a modest motorcycle mishap, Roy Morris is now sporting some hardware holding his collarbone together. Recovery and rehab are going smoothly, but Roy's motoring season is over.

* * *

Margarita and Néstor Cruz spent Thanksgiving break in Italy. While in Florence they attended a performance of *Siegried* at the Teatro Comunale on the 400th anniversary of the invention of opera in that city.

* * *

When you're hot... Phil Schwartz and his playing partner, Dana Eddy, rode a remarkable streak of good luck, coupled with *sick skills*, to tie for *Low Net* at the Virginia State Golf Association 4-Ball Championship. Contested at Independence Golf Club in Midlothian, Phil and Dana carried the Springfield Golf and Country Club banner proudly. *In order to maintain his amateur status, Phil declined to wear a CMG logo.*

* * *

Holiday needs. Drunken holiday office parties are so very 1960's. As you develop your more dignified and sedate holiday event, imagine the fun of sponsoring a group blood donation! The American Red Cross can help: 1-800-GIVE-LIFE.

* * *

SPECIAL WARNING, SECOND ANNOUNCEMENT: AT THE END OF OUR CURRENT LEASE—THAT IS, FEBRUARY 28, 2009—CMG WILL BE RELOCATING TO TYSONS CORNER—THE BUSINESS HUB OF NORTHERN VIRGINIA. OUR NEW ADDRESS WILL BE:

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