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TAX SECTION
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Dear Fellow Tax Section Members,

With the Astros having won the World Series, I am honored to deliver the following report for our fall edition of the *Texas Tax Lawyer*. I would also like to thank our Editor, **Michelle Spiegel**, for her continued commitment and hard work in delivering an outstanding *Texas Tax Lawyer* publication three times a year.

Overview of Our Busy Summer

The new officers met on July 10, 2017 to begin planning for the upcoming year. This was preceded by our Council Retreat which was held in conjunction with the Annual Meeting on Thursday, June 22, 2017. In addition, the Tax Section held its first meeting of the Chairs, Vice Chairs and Council on Friday, August 4, 2017 at the Houston offices of Norton Rose Fulbright.

As a result of these meetings, below are a few documents that have been approved:

1. The Calendar for the 2017-2018 Fiscal Year: http://www.texastaxsection.org/uploads/SBOTCalendar.pdf

2. The List of Chairs and Vice Chairs for the various committees: http://www.texastaxsection.org/DrawOnePage.aspx?PageID=267

3. Statement of Direction: http://www.texastaxsection.org/uploads/Statement%20of%20Direction%202017-2018.pdf

New This Year

The Tax Section is excited to announce a new **free** webcast series "**First Wednesday Tax Update**". The webcasts will be offered the first Wednesday of each month and will always focus on Recent Developments in Federal Income Taxation, and be presented by **Bruce McGovern**, Professor of Law and Director, Tax Clinic, South Texas College of Law Houston (and may occasionally include other guest speakers). We hope you will make plans to watch the "First Wednesday Tax Update" each month, but if you miss it, check back after a few weeks in the Tax Section's 24/7 online library. Watch your email for sign up information! Special thanks to **Sara Giddings,** Co-Chair of the Solo and Small Firm Committee, for coming up with this idea for providing convenient and relevant continuing legal education for our members, and to **Bruce McGovern**, Chair of the General Tax Committee for bringing Sara's idea to life.

Leadership Academy

The Leadership Academy, chaired by **Rob Morris**, strives to train and develop the future leaders of the Tax Section. The deadline for applications for the 2018-2019 Leadership Academy class are due by January 12, 2018. Here is the link to our website to read more and to apply: http://www.texastaxsection.org/uploads/Leadership%20Academy%202018-19%20APPLICATION.pdf

Committee on Governmental Submissions

The Committee on Governmental Submissions, co-chaired by **Henry Talavera**, **Jeffry Blair**, **Ira Lipstet** and **Jason Freeman**, and the substantive committees of the Tax Section have been extremely busy this year providing comments on proposed regulations. The Estate and Gift Tax Committee delivered sets of comments to the IRS on June 23, 2017, August 7, 2017 and August 11, 2017. The comments addressed Notice Issued April 24, 2017, Document Number 2017-08155, 82 FR 18969, in Response to Notice 2017-38 Regarding Proposed Regulations Under Sections 2704 and 6035, and Proposed Regulations Regarding Implementing Centralized Partnership Audit Regime and were primarily authored by Co-Chairs of the Estate and Gift Tax Committee, **Celeste Lawton** and **Laurel Stephenson**. The Partnership and Real Estate Committee, the Tax Controversy Committee, and the Energy and Natural Resources Committee delivered a set of comments to the IRS on August 1, 2017. The comments addressed Proposed Regulation Regarding Implementing Centralized Partnership Audit Regime and were primarily authored by Chair of the Tax Controversy Committee, **Richard Hunn**, Vice Chair of the Partnership and Real Estate Committee, **Leonora ("Lee) Meyercord**, and Chair of the Energy and Natural Resources Committee, **Crawford Moorefield**. On September 18, 2017, **Richard Hunn** and **Lee Meyercord** testified in Washington at the hearing before Treasury and the IRS on the proposed partnership audit regulations. We are very proud of **Lee Meyercord** for being the youngest member of the Tax Section to have ever testified before Treasury and the IRS on behalf of the Tax Section. The Tax Controversy Committee delivered a set of comments to the IRS on August 7, 2017 in Response to Notice 2017-38 Regarding Final Regulations Under Section 7602 on the Participation of a Person Described in Section 6103(n) in a Summons Interview. Those comments were primarily authored by Chair of the Tax Controversy Committee, **Richard Hunn**. A copy of these comments is included in this edition. Several other comment projects are underway, and the State and Local Tax Committee chaired by **Sam Megally** submitted several comments to the Texas Comptroller of Public Accounts. The Committee on Governmental Submissions meets with committee chairs every month to discuss potential and pending comment projects.

Pro Bono Dockets

The Pro Bono Committee, Co-Chaired by **Elizabeth Copeland,** former Chair of the Tax Section who established the pro-bono program, and **Juan Vasquez**, assisted taxpayers at the Houston Small Tax Case docket on September 18, 2017 and at the Dallas Small Tax Case docket on October 2, 2017. Several other similar events are scheduled throughout the state of Texas for the remainder of the calendar year at various locations including Dallas, El Paso, Houston, and Lubbock.

Meeting with the Texas Comptroller's Office

Our annual meeting with the Texas Comptroller of Public Accounts office occurred on Thursday, September 21, 2017 in Austin, Texas. The presentation was provided by the Texas Comptroller's office for the Tax Section of the State Bar, the Texas Society of CPAs and Tax Executives Institute. The morning session included presentations by Tax Section members **Stephen Long**, **Kirk Lyda** and **Charolette Noel**, and by **Karen Currie** of Ernst & Young. The afternoon session included updates on various topics provided by members of the Texas Comptroller of Public Accounts. Many thanks to the Texas Comptroller of Public Accounts **Glenn Hegar** his staff and the State and Local Tax Committee chaired by **Sam Megally** for their hard work and efforts in making this program available to members of the Tax Section.

Law School Outreach Program

The Tax Section's efforts at reaching out to law school students are well underway. The Tax Section met with law students at Southern Methodist University Dedman School of Law on

October 18, 2017, Texas Tech University School of Law on October 19, 2017, and will meet eith students at Baylor University Law School on February 21, 2018. Other law school programs are in the process of being scheduled. Special thanks to **Abbey Garber**, Council member, for his stewardship in connection with the Law School Outreach Program.

Law School Student Scholarships

The application period for law school scholarships is scheduled to open in January of 2018. Applications will be available on our website, so law students and professors will want to be on the lookout for the application! Thanks to **Stephen Long** for spearheading the law school scholarship program this year.

The New and Improved 24/7 Free Online CLE Library

Almost two years ago, the Tax Section launched a newly updated 24/7 Free Online Library thanks to **Michael Threet**, Co-Chair of the CLE Committee and **Alyson Outenreath**, Council member and former Chair of the Tax Section. It continues to be free to members of the Tax Section. It includes over 100 audio and video programs, along with PowerPoint presentations and outlines. And it continues to grow. The following are recent additions to the 24/7 library on the web site. The parenthetical information indicates where on the 24/7 library the recording may be found.

1. Update from the Taxpayer Advocate (What's New)
2. International Returns for Foreign Trusts: Identifying and Planning Around Tax Traps (What's New)
3. Property Tax Update (What's New)
4. Estate Planning Under the New Administration and 2017 (What's New)
5. State Tax Update (What's New)
6. Small Business M & A Issues/Hot Topics (What's New)
7. Oil & Gas Update (What's New)
8. Current Issues & Transaction Structures for Tax-Free Spin-offs (What's New)
9. **Bill Elliott's** Tax Legends Interviews with Fred Goldberg and John Porter (Texas Tax Legends)

Nominations Committee

As directed under the Bylaws, I have recently appointed members of the Nominations Committee. These members include:

David Colmenero (Immediate Past Chair); **Andrius Kontrimus** (2014-2015 Chair); and **Tina Green** (2012-2013 Chair)

As the current Chair, I will serve on the Nominations Committee as an Ex-Officio member.

I would like to extend a special thanks to our past chairs for their continued willingness to serve the Tax Section of the State Bar.

Deadline for the Winter Edition of the *Texas Tax Lawyer*

The deadline for submitting articles and other items for the winter edition of the *Texas Tax Lawyer* is January 12, 2018. Any members interested in submitting articles or other items should contact **Michelle Spiegel** at Michelle.Spiegel@nortonrosefulbright.com.

Upcoming Events

The **20th International Tax Symposium** occurred on November 2 in Dallas and November 3 in Houston. The International Tax Committee is co-chaired by **John Strohmeyer** and **Benjamin Vesely**.

Tax Law in a Day is scheduled for February 9, 2018 in Houston. More details to follow. Tax Law in a Day is an annual all-day survey of tax law basics given under the stewardship of **Lora Davis**, Co-Chair of the CLE Committee.

The annual **Property Tax** Section continuing legal education program will be held in March in Austin. More details to follow. The Property Tax Section is chaired by **Rick Duncan**.

The Tax Section is working on putting together an advanced continuing legal education program involving the partnership audit rules. The program, which will be held in Dallas, likely in May, will have governmental speakers and a panel of other experts. The program is being spearheaded by Co-Chair of the CLE Committee, **Dan Baucum**. More details to come. We are extremely grateful for **Dan Baucum's** involvement and for being such a wonderful supporter of the Tax Section.

At the **Annual Meeting** next June in Houston the Tax Section will present a day of continuing legal education programs. The Annual Meeting chair, **John Strohmeyer**, together with a planning committee including the CLE Committee chairs and a number of Tax Section leaders, including past Tax Section Chair and current Council member **Alyson Outenreath**, have put together a great agenda. More details to come.

Hurricane Harvey Task Force

In response to Hurricane Harvey, a large number of concerned Tax Section leaders (including **Brett Wells**, **Bruce McGovern**, **Alyson Outenreath**, **Juan Vasquez**, **Elizabeth Copeland**, **Rob Morris**, **Jeffry Blair**, **Bob Probasco**, **Dan Baucum**, **Chris Goodrich, Richard Hunn** and the officers, to name a few) formed an unofficial Hurricane Harvey task force. The Tax Section intends to create a Hurricane Harvey corner on its website for the general population. Spearheaded by our academia members of the Council, the Tax Section is working on a video dealing exclusively with Hurricane Harvey tax issues. The task force is also exploring the possibility of providing assistance to taxpayers in connection with statements of grounds for tax refunds in connection with Hurricane Harvey losses. If you are interested in helping with refund claims, please contact **Juan Vasquez** at juan.vasquez@chamberlainlaw.com, **Elizabeth Copeland** at elizabeth.copeland@strasburger.com, **Rob Morris** at robert.morris@nortonrosefulbright.com or me -- stephanie.schroepfer@nortonrosefulbright.com.

Passing of Legal Titans Buford Berry and Richard P. ("Dick") Bogatto

We are deeply saddened by the passing of two legal titans in the Tax Section, **Richard P. ("Dick") Bogatto** and **Buford Berry**. Brief tributes to them are included in this edition of the Texas Tax Lawyer.

Join a Committee

We have an active set of committees, both substantive and procedural as in previous years. Our substantive committees include: Corporate Tax, Employee Benefits, Energy and Natural Resources, Estate and Gift Tax, General Tax Issues, International Tax, Partnership and Real Estate, Property Tax, Solo and Small Firm, State and Local Tax, Tax Controversy, Tax-Exempt Finance, and Tax-Exempt Organizations. In addition, our facilitator committees include: the Committee on Governmental Submissions, Annual Meeting Planning Committee, Continuing Legal Education Committee, Newsletter Committee, and Tax Law in a Day Committee.
Any members interested in joining a committee can do so by visiting our web site at www.texastaxsection.org.

Sponsorships

We are very grateful to our many sponsors of the Tax Section and our events. If your organization would like to become a sponsor, please contact Jim Roberts, Sponsorship Chair, at jvroberts@gpm-law.com.

Contact Information

I look forward to future communications with our members! In the meantime, below is my contact information as well as the contact information for our Tax Section Administrator, **Kelly Rorschach**, if you would like additional information:

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Richard Paul ("Dick") Bogatto

Richard Paul ("Dick") Bogatto, 82, of Houston, Texas passed away April 10, 2017. Born in Galveston, Texas in 1934, he attended Rice Institute (now Rice University) and received a BA in economics and accounting in 1955. Upon graduating from Rice, he attended the University of Texas School of Law and graduated in 1958. In law school, Dick was honored as a member of The Order of the Coif, The Chancellors, Phi Delta Phi, and the Texas Law Review (serving as Associate Editor). After law school, Dick married Frances Moratto, the love of his life, in 1958. (Dick and Frances were the homecoming king and queen at their high school in LaMarque, Texas—a fact that he never revealed and would laugh to find out was discovered by a review of old LaMarque newspapers.)

In 1961, after having served in the U.S. Army Judge Advocate General's Corp in San Antonio, Texas, Dick joined Fulbright, Crooker, Freeman, Bates & Jaworski (now Norton Rose Fulbright US LLP). He began in the Firm's tax department and later established the Firm's ERISA/Employee Benefits department. He served in many Firm leadership roles, including service on the Firm's Executive Committee, the Partner Committee and the Benefits Committee. Dick established a notable national practice in the field of employee benefits, providing legal counsel with respect to thousands of companies and employee benefit plans of all forms. He trained and mentored many of Texas' current attorneys in the field of employee benefits law. During his career, he was generally considered by his peers to be the preeminent national expert in the field of employee benefits tax law.

Dick had many qualities that were in wonderful contrast. He was a very dignified gentleman and yet he also retained throughout his life the joy that usually only children exhibit. Dick was nationally respected and yet was self-effacing and quiet about his achievements. Dick was extremely kind and gracious. He could also be strong and fierce when defending the weak. Dick could be gravely serious when solving a problem, and yet he could make a room explode in laughter with his wonderful sense of humor.

His loud booming laugh still echoes through the halls of Norton Rose Fulbright in the memories of his friends, peers and subordinates. A giant of a man in spirit, Dick treated janitors and CEOs the same and is remembered with much fondness and love by both advantaged and disadvantaged people of all walks of life. He was an avid hunter and fisherman, which passions he passed on to and continued to pursue with his children through his final year.

He is survived by his loving wife of 59 years, Frances, his three children and their spouses, and his four grandchildren.

Buford Preston Berry, Jr.

Buford P. Berry, Jr., 81, passed away on October 2, 2017 in Dallas, Texas surrounded by his family who loved him dearly. Buford was born in Wichita Falls, Texas and raised in Archer City, a small West Texas town made famous by his oldest friend Larry McMurtry. He received his B.B.A. in Accounting from the University of Texas at Austin in 1958, where he was a member of the Kappa Alpha Order and the Naval ROTC. Following graduation, Buford spent two years in Active Duty with the U.S. Naval Reserve and then returned to attend the University of Texas School of Law, where he received his L.L.B. in 1963. There, he was a member of Phi Delta Phi, Quizmaster, Order of the Coif, Chancellors, and Texas Law Review (Associate Note Editor). To say he loved numbers and the law would be a huge understatement.

After being admitted to the Texas Bar in 1963, he moved to Dallas where he began his lifelong career with Thompson, Knight, Simmons & Bullion, now Thompson & Knight LLP. Buford served as the firm's Managing Partner from 1986-1998. He established a national reputation as one of the top oil and gas tax lawyers and tax litigation lawyers in the country. During his career, he represented large corporate taxpayers, including Texaco Inc., Sun Oil Co., Gulf Oil Co., Hamilton Brothers, and Texas Instruments, Inc. He was involved in a number of tax cases which involved precedent-setting issues in the petroleum industry and other areas of tax law. An example is Texaco Inc. V. Commissioner, which involved the transfer pricing of Saudi Arabian crude oil over the period of 1979-1981 and was the largest alleged tax deficiency ever before the Tax Court at the time.

At the time of his passing, he served as Of Counsel at Thompson & Knight. He was a long time member of the American Bar Association and served as Chairman of the Natural Resources Committee/Section of Taxation. He was also Chairman of the Tax Section of the Southwestern Legal Foundation and Secretary of the Advisory Board of the International Oil & Gas Educational Center. Buford was recognized by Woodward/White Inc. as one of The Best Tax Lawyers in America 1987-2017 and by Thompson Reuters as a Texas Super Lawyer 2001-2011. He received the prestigious Outstanding Texas Tax Lawyer Award from the State Bar of Texas Section of Taxation in 2007.

Despite a busy career, Buford always found time to give and was actively involved with numerous civic and charitable organizations, including Goodwill Industries of Dallas, Dallas Citizens Counsel, Dallas Museum of Art, Dallas Symphony and Thompson & Knight Foundation. He was a true sports enthusiast, he loved running, tennis and later in life, golf. He made a "hole in one" playing at Augusta National Golf Club.

Buford was a great leader, a trusted counselor to his clients, and a friend to many, spread all over the world. He will be remembered for his humble spirit and his zest for life and travel. He is survived by his wife Sally, one sister, two children and six grandchildren.

Congratulations to Elizabeth Copeland!

On August 3, 2017, President Trump nominated Elizabeth Copeland to serve as a Judge of the United States Tax Court, to the seat vacated by Judge James Halpern who retired on October 16, 2015. Her nomination is currently pending before the Senate Finance Committee.

On May 4, 2015, President Obama had nominated Copeland to serve as a Judge of the United States Tax Court, to the seat vacated by Judge Diane Kroupa, who retired on June 16, 2014. She received a hearing before the United States Senate Committee on Finance on January 29, 2016. On April 18, 2016, her nomination was reported out of committee by a 26-0 vote. Her nomination expired on January 3, 2017, with the end of the 114th Congress.

Copeland has been board certified in tax law by the Texas Board of Legal Specialization since 2002. *Tax Analysts* named her a 2012 Tax Person of the Year in its national edition of *Tax Notes*. She served as chair of the State Bar of Texas Tax Section from 2013 to 2014. She was named San Antonio Lawyer of the Year by *Best Lawyers* and a Top Ten Tax Attorney in the Nation by *Tax Notes* (along with Chief Justice Roberts).

Ms. Copeland established the U.S. Tax Court Pro Bono Program on behalf of the State Bar of Texas Tax Section. This was the first state program of its kind and is now a model program used by other state bars across the country to assist low income taxpayers.

Copeland is a Certified Public Accountant and holds a B.B.A. with honors from the University of Texas at Austin and a J.D. from the University of Texas School of Law.

Elizabeth Copeland practices law with the firm of Strasburger & Price, LLP, in San Antonio, Texas. She handles all matters pertaining to federal income taxation, including planning and tax controversies, and she is also experienced in dealing with the Internal Revenue Service at the administrative appeals level and in litigation.

TEXAS MARGIN TAX: IS IT TIME FOR THE CURTAIN CALL?

Nikki L. Laing

I. INTRODUCTION[1]

On January 1, 2008, the business landscape changed dramatically for tens of thousands of Texas-based businesses.[2] This change was the result of legislation that made significant revisions to the Texas franchise tax (now commonly called the "margin" tax) by expanding its scope to include entities that never before had been subject to the tax and significantly altering how the tax is calculated.[3] To put it mildly, the margin tax has not been well received,[4] and it is doubtful that it will reach its tenth anniversary.[5]

Since the margin tax's premiere, it has met with poor reviews and been the subject of much criticism,[6] as discussed below in Section III. To make matters worse, revenue from the margin tax has repeatedly failed to meet projections,[7] and the tax has been blamed for impeding the growth of the Texas economy.[8]

The margin tax has survived constitutional challenges in two Texas Supreme Court cases,

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1 This article expands on the author's article, *An Income Tax by Any Other Name Is Still an Income Tax: The Constitutionality of the Texas "Margin" Tax as Applied to Partnerships and Other Unincorporated Associations*, 62 BAYLOR L. REV. 573 (2010).

2 *See* ROBERT W. HAMILTON ET AL., 19 TEXAS PRACTICE SERIES: BUSINESS ORGANIZATIONS § 4.3 (2d ed. 2004 & Supp. 2009–2010) ("Beginning with returns due in 2008, the Texas franchise tax is calculated under a completely new system, and entities not previously subject to the franchise tax (such as limited partnerships) are subject to the tax."); Cynthia M. Ohlenforst et al., *Taxation*, 60 SMU L. REV. 1311, 1311 (2007) ("In 2006, Texas legislators enacted the most substantial franchise tax reform the state has seen since 1907 . . . ."); Ira A. Lipstet, *Franchise Tax Reformed: The New Margin Tax Including 2007 Legislative Changes and Final Comptroller Rules,* 42 TEX. J. BUS. L. 1, 1 (2007) ("[T]he Texas Legislature enacted extensive and significant changes to the franchise tax in May 2006 by way of legislation frequently referred to as 'HB 3.'").

3 *See* HAMILTON ET AL., *supra* note 2; *see also* Jennifer Patterson, *The Margin Tax is Born*, 71 TEX. B.J. 21, 21 (2008) ("The revised franchise tax was dubbed the 'margin tax' both to describe its base, the gross profit margin of a business, and to distinguish it from the former franchise tax on taxable capital and earned surplus. Unlike the old franchise tax imposed only on corporations and limited liability companies, the margin tax is imposed on almost all businesses. Only sole proprietorships, general partnerships owned by natural persons, and certain nonprofit and investment entities are excluded from the tax."); Cynthia M. Ohlenforst et al., *Taxation*, 61 SMU L. REV. 1131, 1135 (2008) (noting that the revised franchise tax is sometimes labeled the "margin tax" since the tax is imposed on a business's "margin"); Lipstet, *supra* note 2 ("The new version of the franchise tax is also referred to as the 'margin tax' because it changes the base of taxation from taxable capital or taxable earned surplus to a new concept of 'taxable margin.'").

4 *See* Section A, *infra*.

5 *See* Section VI, *infra*, discussing the overall dislike of the margin tax, research suggesting that it is hampering the Texas economy, calls for elimination of the margin tax, and recent legislation indicating the impending repeal of the franchise tax.

6 *See* Scott Drenkard, *Special Report No. 226: The Texas Margin Tax: A Failed Experiment*, TAX FOUND. 1, 2 (Jan. 14, 2015), http://taxfoundation.org/sites/taxfoundation.org/files/docs/TaxFoundation_SR226.pdf (observing that "one element of the state's fiscal structure that has created serious controversy is the state's Margin Tax").

7 *See* Section B, *infra*.

8 *See* Section A, *infra*.

summarized below in Section IV, and it is still under attack. In addition, lower courts have issued a number of decisions that have impacted the application of the margin tax, some of which are examined later in Section V.

The margin tax saga appears to be nearing its finale. Section VI, below, looks at the effect the margin tax has had on the Texas economy, as well as at calls from many (including taxpayer groups, economists, academics, and lawmakers) to eliminate it. Last year, Governor Abbott signed into law House Bill 32, which states that "[i]t is the intent of the legislature to promote economic growth by repealing the franchise tax."[9] Interestingly, this bill was called the "Franchise Tax Repeal Act of 2015" in a prior version,[10] but its name was changed to the "Franchise Tax Reduction Action of 2015" in the enrolled version.[11]

II. DEBUT OF THE MARGIN TAX IN 2008

A. A Solution Based on Good Intentions

Although the Texas franchise tax has been in existence since 1893,[12] its current incarnation is the product of the legislature's response to the Texas Supreme Court's 2005 mandate for school finance reform.[13] While an examination of the history of the Texas franchise tax and its many transformations throughout the years is outside the scope of this article,[14] the portion of the tax's history that is relevant to this article is summarized as follows.

Briefly stated, the revised franchise tax was intended to provide a long-term and stable solution to a serious school finance problem.[15] Following a 2005 Texas Supreme Court case which declared the State's system for funding public schools to be in violation of the Texas Constitution, lawmakers were faced with the task of revamping the system within a short timeframe.[16] After working feverishly for several months to determine the best alternative for

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9 Act of June 15, 2015, 84th Leg., R.S., ch. 449 §1(b). House Bill 32 also instructs the comptroller to "conduct a comprehensive study . . . to identify the effects of economic growth on future state revenues" and issue a report that identifies "revenue growth allocation options to promote efficiency and sustainability in meeting the revenue needs of this state . . . upon repeal of the franchise tax." *Id.* at §5.

10 http://www.capitol.state.tx.us/tlodocs/84R/billtext/pdf/HB00032S.pdf#navpanes=0 (last visited October 31, 2016).

11 Act of June 15, 2015, 84th Leg., ch. 449, §1(a).

12 *In re* Nestle USA, Inc., 387 S.W.3d 610, 611–12 (Tex. 2012).

13 *See In re* Allcat Claims Serv., L.P., 356 S.W.3d 455, 457–59 (Tex. 2011) (discussing the school funding case Neeley v. West Orange–Cove Consol. Indep. Sch. Dist., 176 S.W.3d 746, 753–54 (Tex. 2005) and the events that followed).

14 For in-depth coverage of the history of the margin tax, see Alyson Outenreath, *Call to the Texas Legislature: The Franchise Tax Needs Substantive Changes, Not Just Rate Reductions*, 47 ST. MARY'S L.J. 351, 353–54, 355–61 (2015); Josh Haney & Bruce Wright, *Fiscal Notes: The History of the Texas Franchise Tax*, TEX. COMPTROLLER OF PUB. ACCOUNTS, 1, 1–6 (May 2015), https://www.comptroller.texas.gov/economy/fiscal-notes/2015/may/fn.pdf; Byron F. Egan, Choice of Entity Decision Tree, Presentation at the State Bar of Texas 13th Annual Advanced Business Law Course, 3, 413–15 (Nov. 2015); Jimmy Martens & Amanda Traphagan, *Margin of Error: Fixing the Texas Franchise Tax After* Allcat, 30 J. ST. TAX'N 37, 37 (2012); Cynthia M. Ohlenforst, *The New Texas Margin Tax: More Than a Marginal Change to Texas Taxation*, 60 TAX LAW 959, 959–62 (2007).

15 *See In re Allcat*, 356 S.W.3d at 458.

16 *See id.* at 457–59; *see also* Haney & Wright, *supra* note 14, at 4; Outenreath, *supra* note 14, at 353–54.

financing public education within the time limit set by the courts, the 79th Legislature enacted the amendments to the Texas Tax Code that overhauled the structure of the Texas franchise tax into the version that took effect on January 1, 2008, and still exists today.[17]

B. The Not-So-Basic "Basics" of the Margin Tax Calculation

To understand taxpayers' reaction to the margin tax and the various legal attacks against the tax discussed later in this article, it is helpful to be somewhat familiar with the basics of the margin tax calculation.[18] Prior to 2008, the "old" Texas franchise tax applied only to corporations and limited liability companies—partnerships and other noncorporate entities such as professional associations were not subject to the tax.[19] In contrast, the margin tax, which took effect on January 1, 2008, is imposed on partnerships and other unincorporated entities in addition to corporations and limited liability companies.[20] Under the "old" franchise tax, an entity's franchise tax liability was calculated based on either capital or earned surplus.[21] Beginning in 2008, an entity's liability is calculated as a percentage of its "taxable margin."[22]

Determining an entity's margin tax liability can be an extremely complex task.[23] However, a simple outline of how the margin tax is calculated follows. Generally speaking, the first component of the margin tax calculation is an entity's "total revenue."[24] Once an entity's "total revenue" is determined (which is not as clear-cut as the label indicates!), one of three deductions may be subtracted from "total revenue" to arrive at the second component of the margin tax calculation: the entity's "margin."[25] Some entities can calculate "margin" by subtracting "cost of goods sold" from "total revenue."[26] Entities that are allowed the cost-of-goods-sold deduction are usually (but not always) businesses that sell or manufacture products (in contrast to providing services).[27] Some entities can calculate "margin" by subtracting "compensation" from "total revenue."[28] Businesses that choose the compensation deduction

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17 *See id.*

18 Some basic margin tax concepts are discussed in this subsection to assist readers who may be unfamiliar with the tax. This section in no way provides comprehensive coverage of all of the components of the margin tax, and it omits a myriad of factors and exceptions that may apply when calculating margin tax.

19 *See* HAMILTON ET AL., *supra* note 2.

20 TEX. TAX CODE ANN. § 171.0002(a) (West 2015); *see* HAMILTON ET AL., *supra* note 2; Ohlenforst, *supra* note 2, at 1319 ("A significant change to the tax is its application for the first time to partnerships."). The revised franchise tax applies to nearly all types of partnerships and unincorporated associations, except for sole proprietorships and general partnerships "the direct ownership of which is entirely composed of natural persons" and "the liability of which is not limited under a statute of this state or another state." TAX § 171.0002(b).

21 Eric L. Stein, *Texas Revised Franchise Tax*, 2400-2d Tax Mgmt. Multistate Tax Portfolios 2400.02.A.1 (2009) ("The revised franchise tax is calculated based on a taxable entity's 'taxable margin,' instead of the former tax base of taxable capital and taxable earned surplus.").

22 *Id.*; *see* TAX § 171.002; *see* TAX § 171.101.

23 *See* Drenkard, *supra* note 6, at 4 (full-page diagram of the margin tax liability calculation).

24 *See* TAX §§ 171.101(a)(1)(B), 171.1011(c).

25 *See id.* § 171.101(a)(1). Alternatively, an entity with total revenue of $20 million or less may choose the "E-Z Computation" set forth in § 171.1016. *See* notes 31–33, *infra*.

26 *See* TAX §§ 171.101(a)(1)(B)(ii)(a)(1), 171.1012.

27 *See id.* § 171.1012; *see also* Section C. *infra*, discussing cases pertaining to the cost-of-goods-sold deduction.

28 *See* TAX §§ 171.101(a)(1)(B)(ii)(a)(2), 171.1013.

are typically service providers.[29] Alternatively, rather than computing the statutorily-defined cost-of-goods-sold or compensation deductions to calculate "margin," an entity can simply deduct a flat 30 percent from its "total revenue."[30]

After determining an entity's "margin," an apportionment factor is applied to the "margin" to reach the third component of the margin tax calculation: the entity's "taxable margin."[31] Finally, once an entity's "taxable margin" is calculated, one of two tax rates is applied to the entity's "taxable margin" to arrive at the entity's margin tax liability.[32] The tax rate in effect for 2016 is 0.375 percent for retailers and wholesalers and 0.75 percent for all other businesses.[33]

As may be evident from the preceding outline of the "basic" margin tax calculation, what began as the Texas legislature's idea for a way out of the 2005 school finance dilemma quickly morphed into a major headache for taxpayers and the comptroller alike.[34]

III. THE REVIEWS ARE IN

A. Reaction to the Margin Tax

The drastic changes to the franchise tax discussed above came as a surprise to many Texans.[35] The margin tax was collected for the first time in May 2008, and "[a]t that point, many taxpayers awoke to its implications for the first time."[36] The margin tax has had a significant effect on thousands of individuals who conduct business via partnerships and unincorporated associations.[37] Professionals and small-business owners who had operated for years as partnerships or professional associations were suddenly faced with Texas tax bills in

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29 *See id.* § 171.1012(a)(3)(B)(ii) (excluding services from the definition of "goods" for purposes of the cost-of-goods-sold deduction).

30 *See id.* § 171.101(a)(1)(A)(i) (defining an entity's margin as "70 percent of the taxable entity's total revenue," which is mathematically the same as deducting 30 percent of total revenue).

31 *Id.* § 171.101(a)(2)–(3). To keep this outline of the margin tax calculation simple, it will not include the "other allowable deductions" referenced in subsection (a)(3). *Id.* at (a)(3). For an entity that has chosen the "E-Z Computation," the apportionment factor is applied directly to the entity's total revenue. *See id.* § 171.1016(b)(2).

32 *Id.* § 171.002(a)–(b). For an entity that has chosen the "E-Z Computation," the statutory rate is applied directly to the entity's total revenue that is apportioned to the state of Texas. *See id.* § 171.1016(b).

33 *Id.* § 171.002(a)–(b). For taxpayers choosing the "EZ Computation," the rate is .331 percent. *Id.* § 171.1016(b).

34 *See* Haney & Wright, *supra* note 14, at 1, 5. "[G]iven the sweeping nature of the changes to the franchise tax, virtually every facet of the new system soon faced administrative and legal challenges." *Id.*

35 Letter from Carole Keeton Strayhorn, Tex. Comptroller of Pub. Accounts, to Rick Perry, Tex. Governor (May 2, 2006) (on file with author) (writing that the revised franchise tax legislation will "require 200,000 Texas businesses that currently do not pay taxes to either file or pay taxes," and that "[m]ost of that astounding number of Texans will not realize they are in this group of new taxpayers until they are told before the tax is due in May of 2008").

36 Billy Hamilton, *Déjà Vu All Over Again—Texas Considers Property and Business Tax Reform*, 51 ST. TAX NOTES 523 (2009). Billy Hamilton was the deputy comptroller at the Texas Office of the Comptroller of Public Accounts from 1990 until 2006. *Id.*

37 *Id.* (noting that the new tax, as applied to partnerships and other non-corporate business entities, "made literally thousands of businesses statewide into new taxpayers, and generally they were a disgruntled lot").

2008 for the first time in the history of the State.[38] In addition to the cold reception from businesses that had not previously been subject to the Texas franchise tax, the new margin tax quickly drew criticism from taxpayers and experts across the board.[39] One reason for the criticism of the new margin tax is that Texas is known for being "tax-friendly toward businesses," and Texans are generally not receptive toward new taxes.[40] It has been noted that "[i]n a state that views all taxes with disdain, few levies have drawn more scorn than the Texas [margin] tax."[41]

Aside from Texans' general anti-tax attitude, the margin tax has been severely criticized for being complex in its structure and unfair in its application.[42] The calculation of the tax has been described as being "overly burdensome,"[43] with its "unique structure . . . [being] . . . a problem for taxpayers, legislators, and judges."[44] "The costly, complex nature of the margin tax makes it highly unpopular."[45] Commentators have referred to the "contortions" required to calculate the margin tax[46] and observed that taxpayers "often [devote] more time and resources in determining [the margin] tax bill than what is required to pay the tax itself."[47] One recent report found the margin tax to be inferior to business tax structures found in most other states.[48] Along with criticism of the complicated structure of the margin tax, objections to the margin tax have run the gamut from complaints that it is unfair[49] to allegations that it is

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38 *See supra* notes 35–37 and accompanying text.

39 *See* Drenkard, *supra* note 6, at 2 (noting that the margin tax "has attracted criticism from experts in the field, attracted lawsuits from businesses that must comply with it, and attracted legislative changes as political pressure around the tax continues to mount").

40 Outenreath, *supra* note 14, at 352–53; *see* Haney & Wright, *supra* note 14, at 1 (describing the margin tax as "controversial . . . given the Legislature's consistent focus on maintaining Texas' business-friendly reputation").

41 Loren Steffy, *Margin of Error*, TEX. MONTHLY (May 2015), http://www.texasmonthly.com/politics/margin-of-error/.

42 *See* Drenkard, *supra* note 6, at 14 (calling the margin tax "one of the worst business taxes in the country").

43 Scott Drenkard, *Businesses Love Texas, Except this One Tax that Holds the State Back*, TAX FOUND. (Jan. 8, 2016), http://taxfoundation.org/blog/businesses-love-texas-except-one-tax-holds-state-back; *see also Final Report of the TCCRI State Taxation Task Force*, TEX. CONSERVATIVE COAL. RES. INST., 1, 9 (2013), http://www.txccri.org/wp-content/uploads/2013/01/Franchise-Tax-Report.pdf (describing the margin tax as being "unnecessarily burdensome").

44 Drenkard, *supra* note 6, at 2.

45 Vance Ginn, Ph.D. and The Honorable Talmadge Heflin, *Economic Effects of Eliminating Texas' Business Margin Tax*, TEX. PUB. POLICY FOUND., at 4 (Mar. 2015), http://www.texaspolicy.com/library/doclib/MarginTax-CFP.pdf.

46 Drenkard, *supra* note 43.

47 Ginn & Heflin, *supra* note 45, at 5.

48 The Tax Foundation's 2016 State Business Tax Climate Index assigned a rank of 41 to the Texas margin tax, with a rank of 1 being the best and a rank 50 being the worst. *See* Jared Walczak, et al., *2016 State Business Tax Climate Index*, TAX FOUND.; *but see* Maria Garnett, *Fiscal Notes: Starting a New Business*, TEX. COMPTROLLER OF PUB. ACCOUNTS, 1, 3 (Feb. 2016), http://comptroller.texas.gov/fiscalnotes/feb2016/starting.php (discussing a number of other reports giving more favorable reviews of Texas' tax climate); *see also* Raymond J. Keating, *Small Business Tax Index 2015: Best to Worst State Tax Systems for Entrepreneurship and Small Business*, SMALL BUSINESS & ENTREPRENEURSHIP COUNCIL, 3, 4 (Apr. 2015), http://www.sbecouncil.org/wp-content/uploads/2015/04/BTI2015SBECouncil.pdf (assigning Texas a rank of 3 (with a rank of 1 being the best and 50 being the worst) on its 2015 Small Business Tax Index).

49 *See generally* Joseph Henchman, *Texas Margin Tax Experiment Failing Due to Collection Shortfalls, Perceived Unfairness for Taxing Unprofitable and Small Businesses, and Confusing Rules*, TAX FOUND. 1, 2 (Aug. 17, 2011), http://taxfoundation.org/sites/taxfoundation.org/files/docs/ff279.pdf.

unconstitutional.[50] Unfortunately, the more than 400 bills that have been authored relating to the margin tax since its inception have done little to remedy its shortcomings to the satisfaction of most critics.[51]

B. Dismal Financial Performance

Regrettably for the state's coffers, the position held by opponents of the margin tax has been bolstered by its poor financial performance.[52] Since its inception, the margin tax has "performed considerably below the state's expectations."[53] It has been deemed a "failure"[54] and called the "most counterproductive part of the [Texas] tax code."[55] According to some researchers, the "margin tax is a poor and inefficient mechanism for generating state revenues, placing a tremendous burden on entrepreneurs and small businesses that affects all Texans."[56]

Ultimately, rather than solving the state's school finance crisis as Texas lawmakers had envisioned, the margin tax has frustrated taxpayers across the country, attracted endless criticism, and disappointed stakeholders across the board.[57]

IV. CONSTITUTIONAL CHALLENGES IN THE TEXAS SUPREME COURT

The margin tax has weathered several state and federal constitutional challenges asserted in two Texas Supreme Court cases.[58]

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50 *See infra* Section IV.

51 *See* the Bill Search feature of Texas Legislature Online, http://www.capitol.state.tx.us/Search/BillSearch.aspx (last visited Nov. 7, 2016).

52 *See Final Report of the TCCRI*, *supra* note 43, at 14–15; Michael J. Chow, *Phasing Out the Texas Business Franchise Tax: The Impact on Private Sector Employment*, NFIB RES. FOUND. (Mar. 8, 2013), https://s3.amazonaws.com/NFIB/AMS%20Content/Attachments/2/1-67446-PIPLUS_TX_FRANCHISE_TAX.pdf.

53 Haney & Wright, *supra*, note 14, at 5.

54 Sarah Tober, *Franchise Tax Still a Thorn in Small Business Side in Texas*, NAT'L FED'N OF INDEP. BUSINESS (Mar. 30, 2016), http://www.nfib.com/content/news/tax-help/franchise-tax-still-a-thorn-in-small-business-side-in-texas-73486/ (quoting NFIB Executive Director Will Newton); Ginn & Heflin, *supra* note 45, at 4.

55 Ryan H. Murphy, *Policy Report No. 357: Benefits to the Poor of Texas Franchise Tax Repeal,* NAT'L CTR. FOR POLICY ANALYSIS, 1, 3 (June 2014), http://www.ncpa.org/pdfs/st357.pdf.

56 *See* Ginn & Heflin, *supra* note 45.

57 *See* Steffy, *supra* note 41 (writing that "many lawmakers criticize it for generating less revenue than it was supposed to.").

58 The constitutional challenges in the cases discussed in Section IV were taken directly to the Texas Supreme Court under the special provision included in the legislation revising the Texas Franchise Tax Act, which gives the supreme court exclusive and original jurisdiction over a challenge to the constitutionality of the margin tax. *See* Act of May 2, 2006, 79th Leg., 3d C.S., ch. 1, §24(a), 2006 Tex. Gen. Laws 1, 40 ("The supreme court has exclusive and original jurisdiction over a challenge to the constitutionality of this Act or any part of this Act and may issue injunctive or declaratory relief in connection with the challenge.").

A. *Allcat*

1. Unconstitutional Tax on Natural Person's Share of Partnership Income?

The first constitutional challenge was brought to the Texas Supreme Court in July of 2011 by a limited partnership and its partner in *In re Allcat Claims Serv., L.P.*[59] In *Allcat*, a limited partnership became subject to the margin tax under the new law that went into effect in 2008.[60] Some of the partners were natural persons.[61] The petitioners in *Allcat* claimed that the imposition of the margin tax on the portion of the partnership's margin that represented its natural-person partners' shares of partnership income violated the Texas Constitution.[62]

The petitioners' claim was based on Article VIII, Section 24 of the Texas Constitution, which states the following:

> A general law enacted by the legislature that imposes a tax on the net incomes of natural persons, including a person's share of partnership and unincorporated association income, must provide that the portion of the law imposing the tax not take effect until approved by a majority of the registered voters voting in a statewide referendum held on the question of imposing the tax.[63]

The petitioners in *Allcat* asserted that the margin tax is unconstitutional because it taxes a natural person's share of partnership income but Texas voters did not approve the tax.[64] In support of its assertion that the margin tax imposes a tax on a natural person's share of partnership income in violation of the Texas Constitution, the petitioners advanced a two-pronged argument.[65] The first prong of the petitioners' argument was that the margin tax constitutes an "income tax" because the margin tax calculation accords with the common dictionary definition of income tax, the definition of income tax found in the Texas Tax Code, and the concept of income tax as defined in case law.[66] The second prong of the petitioners' argument was that the margin tax constitutes a tax on a natural person's share of partnership income because it indirectly imposes a tax on the share of partnership income that is allocated to a partnership's natural-person partners.[67] In presenting these arguments to the Court, the petitioners faced the difficult (if not impossible!) task of reconciling accounting concepts with legal principles.

The Court declined to address the first prong and decide whether the margin tax is an

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59 *See generally* 356 S.W.3d 455, 457 (Tex. 2011).

60 *Id.* at 459.

61 Original Petition at 3, *In re Allcat*, 356 S.W.3d 455 (No. 11-0589).

62 *In re Allcat*, 356 S.W.3d at 459. The petitioners in *Allcat* also brought a claim based on the equal and uniform taxation clause of the Texas Constitution, which was rejected for lack of jurisdiction. *See id.* At 470–71.

63 TEX. CONST. art. VIII, § 24(a).

64 Original Petition, *supra* note 61, at 5.

65 *See id.* at 6–12. *See also* Brief of Amici Curiae Nikki Laing, CPA et al. in Support of Plaintiffs at 16–33, *In re Allcat,* 356 S.W. 3d 455 (No. 11-0589).

66 Original Petition, *supra* note 61, at 6–9.

67 *Id.* at 9–12.

income tax.[68] As for the second prong, the Court analyzed the issue in the context of the aggregate versus entity theories of partnership law.[69] The Court noted that "under Texas law the entity theory applies to partnership income and profits. Individual partners do not own any of either while they remain in the partnership's hands and have not been distributed to the partners."[70] The Court further reasoned that, "while a partner's interest in the partnership represents the right to receive the partner's share of partnership profits when they are distributed, it does not follow that for purposes of the Texas franchise tax such right constitutes a partner's 'share' of any partnership income or profits while the partnership retains the income and profits without having distributed any of them to the partner."[71] Based on this reasoning, the Court found that the margin tax constitutes a tax imposed on a partnership as an entity and not on its partners.[72] Because the Court found that the margin tax was not imposed on the natural partners in *Allcat,* the Court held that the margin tax does not violate the Texas Constitution's prohibition (absent voter approval) of a net-income tax on a natural person's share of partnership income.[73]

2. Income Tax?

The *Allcat* case did not answer the question of whether the margin tax constitutes an income tax.[74] The Texas Constitution prohibits, absent voter approval, a "tax on the net incomes of natural persons, including a person's share of partnership and unincorporated association income."[75] Upon the introduction of the margin tax, many tax experts classified it as an income tax.[76] As one commentator stated, "[a]lthough the State of Texas vigorously

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68 *In re Allcat*, 356 S.W.3d at 463, 469 n.10.

69 *See id.* at 463–70.

70 *Id.* at 468.

71 *Id.* at 468–69.

72 *Id.* at 470. The Court based its decision on legal concepts such as property ownership and entity versus aggregate theories of partnership law. However, in the author's view, accounting concepts should have been considered, as well. In the author's opinion, "income" can be thought of as purely an accounting concept separate from concepts of property law and claims of ownership—an intangible figure that results from subtracting certain deductions (which may consist of actual cash outlays or artificially-timed expenses such as depreciation or amortization) from revenues (which may consist of actual cash receipts or artificially-timed income recognition) and is used for purposes of calculating items such as taxes and allocations. The term "income" is an intangible number that is used for accounting purposes. "Income" is not equivalent to tangible cash or property that is actually possessed by a partnership or distributed by a partnership to a partner. Therefore, property-law or entity-theory concepts are not necessarily relevant in the analysis of an issue involving a tax on "income."

73 *Id.* at 457, 470.

74 *See supra* notes 66, 68 and accompanying text.

75 TEX. CONST. art. VIII, § 24(a). "'Natural person' means a human being or the estate of a human being. The term does not include a purely legal entity given recognition as the possessor of rights, privileges, or responsibilities, such as a corporation, limited liability company, partnership, or trust." TEX. TAX CODE ANN. § 171.0001(11-a) (West 2015).

76 *See* Lipstet, *supra* note 2, at 3 n.7 (noting that "the Financial Accounting Standards Board (FASB) has apparently concluded that the margin tax is, for purposes of FASB Statement No. 109 (Accounting for Income Taxes) and financial accounting reporting purposes, an income tax."); Stein, *supra* note 21, at 2400.04 (writing that "[t]he revised franchise tax has the characteristics of an income tax since it is determined by applying a tax rate to a base which takes into account both revenues and expenses, namely cost of goods sold or compensation."); L. A. Lorek, *Business Tax in Eye of the Beholder*, SAN ANTONIO EXPRESS-NEWS, Apr. 5, 2006 (quoting Richard Joseph, Ph.D., JD, and director of the University of Texas professional accounting program, as saying, "With all the deductions the

defends its position that the margin tax is not an income tax, for all practical purposes, the margin tax is, in effect, a veiled income tax."[77]

To understand why the margin tax is considered by some to be a veiled income tax, a condensed explanation of its calculation is necessary. As mentioned previously in Section B, to determine Texas margin tax liability, a taxable entity begins by determining its total revenue.[78] The Texas Tax Code instructs that a taxable entity's total revenue for margin tax purposes is determined by using numbers reported on the entity's federal income tax return.[79] Therefore, an entity's Texas margin tax is calculated using figures taken directly from the entity's federal income tax return.[80] Once a taxable entity determines its total revenue (using figures directly from its federal income tax return), the entity then subtracts certain expenses that it reported on its federal income tax return[81] and other statutorily-defined deductions and exemptions to arrive at its "taxable margin."[82] After an entity has computed its taxable margin, it multiplies its taxable margin by the applicable tax rate in order to calculate the amount of margin tax it owes to the State of Texas.[83]

Compare how the taxable margin is calculated with how net income is calculated, considering that net income is defined as "[t]otal income from all sources minus deductions,

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proposed tax bill allows businesses to take, the new franchise tax begins to look more like an income tax . . . ."); Brad J. Brookner & Russell D. Brown, *Sweeping Texas Franchise Tax Changes: The Margin Tax*, TAX ADVISER, 550–51 (Sept. 2006) (stating that "[w]hile H.B. 3 states that the modified tax is 'not an income tax,' the current view of the authors' firm [(Deloitte Tax LLP)] is that the margin tax is a tax on income . . . ."); Andrew Essington, *Texas Margin Tax: The Impact on Investment Real Estate*, http://www.ainorthtexas.org/store/Essington.pdf (last visited Nov. 7, 2016) (stating that the "[m]argin tax is effectively a state income tax to the ownership entity.").

77 Jeff Slade, *Drilling Down the Texas Margin Tax: A Gusher or Dry Hole of Taxes for the Oil & Gas Industry?*, 36 TEX. TAX LAW 28, 28 (2008). *See also* Cynthia M. Ohlenforst et al., *Taxation*, 59 SMU L. REV. 1565, 1577 (2006) (observing that the margin tax "was designed to . . . avoid being categorized as a net income tax" and that "[a]lthough there was significant support for the plan in some quarters, others attacked the plan . . . [by] . . . claiming that the tax on gross receipts net of deductions constituted a net income tax of individual partners in limited partnerships, thereby running afoul of the Texas constitutional prohibition on a net income tax on individuals.").

78 *See* TAX §§ 171.101(a)(1)(B), 171.1011(c).

79 *Id.* § 171.1011(c)(1) ("[F]or the purpose of computing its taxable margin . . . the total revenue of . . . a taxable entity treated for federal income tax purposes as a corporation [is] an amount computed by [adding]: (i) the amount reportable as income on line 1c, Internal Revenue Service Form 1120; (ii) the amounts reportable as income on lines 4 through 10, Internal Revenue Service Form 1120 . . . ."); *see also id.* § 171.1011(c)(2) ("[F]or a taxable entity treated for federal income tax purposes as a partnership, an amount computed by [adding]: (i) the amount reportable as income on line 1c, Internal Revenue Service Form 1065; (ii) the amounts reportable as income on lines 4, 6, and 7, Internal Revenue Service Form 1065; (iii) the amounts reportable as income on lines 3a and 5 through 11, Internal Revenue Service Form 1065, Schedule K; (iv) the amounts reportable as income on line 17, Internal Revenue Service Form 8825; (v) the amounts reportable as income on line 11, plus line 2 or line 45, Internal Revenue Service Form 1040, Schedule F . . . .").

80 *Id.* § 171.1011(c)(1)–(2).

81 *See id.* §§ 171.101(a), 171.1011(c).

82 *Id.* §§ 171.1012–.1013. As discussed *supra* in note 31 and accompanying text (but not relevant to the analysis of whether the margin tax constitutes an income tax) an apportionment factor is applied to the margin of entity doing business in multiple states. *See id.* § 171.101(a)(2)–(3).

83 *Id.* § 171.002(a)–(b). For an entity that has chosen the "E-Z Computation," the statutory rate is applied directly to the entity's total revenue that is apportioned to the state of Texas. *See id.* § 171.1016(b).

exemptions, and other tax reductions."[84] In addition, compare the calculation of the margin tax to the Texas Tax Code's definition of income tax: "a tax imposed on or measured by net income including any tax imposed on or measured by an amount arrived at by deducting expenses from gross income, one or more forms of which expenses are not specifically and directly related to particular transactions.[85]

As an illustration, assume a Texas service provider (law firm, accounting firm, doctor's office, janitorial service, etc.) has total revenues of $3 million and payroll expenses of $2 million. Following is a simplified example of how the entity's margin tax would be calculated on its 2016 franchise tax report:[86]

Total Revenue as Reported to IRS	$3,000,000
Less: Deductible Payroll Expenses	-2,000,000
Taxable Margin	**1,000,000**
Multiplied by tax rate	.075 %
Franchise Tax	**7,500**

Now, here is a simplified example of how the entity's income tax would be calculated for both federal income tax and financial-reporting purposes:[87]

Total Revenue as Reported to IRS	$3,000,000

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84 BLACK'S LAW DICTIONARY (10th ed. 2014). The author would point out that nothing in the dictionary definition of net income requires that all possible deductions be subtracted from total income in order to arrive at net income

85 *See* TAX § 141.001. This is the only definition of income tax found in the Texas Tax Code. Although this definition is not included in the Franchise Tax chapter of the Tax Code, it is found in the Multistate Tax Compact chapter, the purposes of which are to "[f]acilitate proper determination of state and local tax liability of multistate taxpayers," "[p]romote uniformity or compatibility in significant components of tax systems," and "[f]acilitate taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration." *Id.* Note that the term income tax has been defined in this manner in the Tax Code since 1982, and "[w]ords and phrases that have acquired a technical or particular meaning, whether by legislative definition or otherwise, shall be construed accordingly." TEX. GOV'T CODE ANN. § 311.011(b) (West 2015). Contrast the Tax Code's definition of income tax to its definition of gross receipts tax: "'Gross receipts tax' means a tax . . . which is imposed on or measured by the gross volume of business, in terms of gross receipts or in other terms, and in the determination of which no deduction is allowed which would constitute the tax an income tax." TAX § 141.001. As with the dictionary definition of "net income," the author would point out that nothing in the Texas Tax Code's definition of income tax requires every expense incurred by an entity to be deducted from gross income in order for a tax to constitute an income tax.

86 Note that this is an extremely simplified illustration showing the tax liability of a service provider taxed at .75 percent (in contrast to a retailer or wholesaler, who would be taxed at 0.375 percent), as computed by the franchise tax calculator available at the Texas Comptroller's website. *See Franchise Tax Calculation*, TEX. COMPTROLLER, https://www.comptroller.texas.gov/forms/hb3calc.pdf (last visited October 19, 2016). The scope of this Article does not allow for a detailed explanation of all aspects of the margin tax calculations, such as the optional "E-Z Computation." *See* TAX § 171.1016. Readers should consult additional sources for guidance on specific calculations, such as Chapter 171 of the Texas Tax Code, the Texas Comptroller of Public Accounts website, Franchise Tax, https://www.comptroller.texas.gov/taxes/franchise/ (last visited Oct. 19, 2016), and the sources cited in this Article.

87 *See* IRS Form 1120 (2015), INTERNAL REVENUE SERVICE, https://www.irs.gov/pub/irs-pdf/f1120.pdf; *see also* IRS Form 1040 (2015), INTERNAL REVENUE SERVICE, https://www.irs.gov/pub/irs-pdf/f1040.pdf and IRS Form 1040, Schedule C (2015), INTERNAL REVENUE SERVICE, https://www.irs.gov/pub/irs-pdf/f1040sc.pdf (all last visited Nov. 7, 2016).

Less: Deductible Payroll Expenses	2,000,000
Taxable Income	**1,000,000**
Multiplied by tax rate	.15 %
Federal Income Tax	**150,000**

Is there a meaningful difference between the two calculations for purposes of classifying the type of tax imposed on the service provider? The Financial Accounting Standards Board (FASB), the board that sets national accounting standards, did not see a difference.[88] Shortly after the new franchise tax regime was signed into law, upon inquiries from constituents, national accounting firms, and other interested parties, FASB staff "concluded that the Texas Franchise Tax is an income tax because the tax is based on a measure of income."[89] Furthermore, the FASB's Technical Application and Implementation Activities Committee (TA&I Committee) determined that "the Texas Franchise Tax [is] an income tax that should be accounted for under Statement 109 and that there [will] not be diversity in the conclusions reached by preparers, auditors, and regulators on whether the Texas Franchise Tax [is] an income tax."[90]

Perhaps realizing the similarities between margin tax and income tax calculations, the Texas legislature apparently attempted to dispel any constitutional misgivings up front by stating in the original margin tax legislation that it "is not an income tax."[91] However, merely labeling the tax as a margin tax instead of an income tax does not make it so.[92] Experts have recognized that the structure of the margin tax fits the definition of an income tax, calling it "a hybrid of a gross receipts tax and an income tax"[93] and "a badly designed business profits tax."[94] Experts have also noted that the margin tax "is imposed on firms' profits" and "has

[88] *See* Lipstet, *supra* note 2, at 3 n.7 ("[T]he Financial Accounting Standards Board (FASB) has apparently concluded that the margin tax is, for purposes of FASB Statement No. 109 (Accounting for Income Taxes) and financial accounting reporting purposes, an income tax.").

[89] Minutes of the August 2, 2006 Board Meeting on Potential FSP: Texas Franchise Tax, Financial Accounting Standards Board, http://www.fasb.org/jsp/FASB/Page/08-02-06_texas_franchise_tax.pdf.

[90] *Id.* Because the TA&I Committee did not anticipate disparity in the treatment of the margin tax as an income tax for financial-reporting purposes, at a meeting in 2006, the FASB declined to pursue a project to provide formal guidance to taxpayers regarding the proper treatment of the Texas Revised Franchise Tax. *See id.*; *see also* Byron F. Egan, *Choice of Entity Decision Tree After Margin Tax and Texas Business Organizations Code*, 42 TEX. J. BUS. L. 71, 106 (2008).

[91] *See* Act of May 2, 2006, 79th Leg., 3d C.S., ch. 1, §21, 2006 Tex. Gen. Laws 1, 38 (H.B. 3, which implemented the current margin tax structure, states: "The franchise tax imposed by Chapter 171, Tax Code, as amended by this Act, is not an income tax . . . .").

[92] *See* John Gamino, *So-called 'Margin Tax' Violates Truth in Labeling*, HOUS. BUS. J., Jan. 22, 2007, http://houston.bizjournals.com/houston/stories/2007/01/22/editorial4.html; *see also* Bishop v. District of Columbia, 401 A.2d. 955, 958 (D.C. 1979) ("As to the characterization of a tax, it is fundamental that the nature and effect of a tax, not its label, determine if it is an income tax or not."); *see also* Ohlenforst, *supra* note 14, at 977 ("Legislators worked diligently to draft a tax that will not, they hope, be an income tax for purposes of the . . . Texas constitutional amendment that prohibits the imposition of an income tax on the net income of natural persons unless the tax is approved in a statewide referendum. . . . It appears clear, however, that for generally accepted accounting purposes, the margin tax will be considered an income tax that should be accounted for under FASB Statement No. 109, Accounting for Income Taxes." (footnotes omitted)).

[93] Drenkard, *supra* note 6, at 7 n.17.

[94] John L. Mikesell, *Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance* 4 (Tax Foundation Council On State Taxation, Background Paper No. 53, 2007),

taken on the features of a distortionary income tax on business."[95] Although the Texas Supreme Court managed to skirt the income tax question in *Allcat*,[96] the issue has again reared its head in the recent case *Graphic Packaging Corp. v. Hegar*, discussed later in Section V.B. Business owners, advisors, and academics across the country are watching the *Graphic* case intently to see how the Texas Supreme Court will answer this question.

3. Constitutional When Imposed on Single-Owner Unincorporated Associations?

In addition to leaving the income tax question open, the *Allcat* case did not address the constitutionality of the margin tax as applied to a professional association (PA) or limited liability company (LLC) that has a natural person as its sole owner and is disregarded for federal income tax purposes.[97] LLCs and PAs both fall under the "unincorporated association" umbrella of art. VII, § 24(a) of the Texas Constitution.[98] Therefore, the prohibition against a "tax on the net incomes of natural persons, including a person's share of . . . unincorporated association income" is applicable in the context of LLCs and PAs.[99] If the margin tax meets the definition of an income tax,[100] query how the margin tax, when imposed on a single-member LLC owned by a natural person and taxed as a disregarded entity for federal income tax purposes, is not prohibited absolutely by the constitution as an income tax on a natural person's income.[101]

Although Texas does not have a personal income tax that is labeled as such by the legislature, it can be argued that the margin tax operates as a personal income tax when imposed on a flow-through entity owned entirely by one person.[102] This concept is reflected in

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http://taxfoundation.org/sites/taxfoundation.org/files/docs/bp53.pdf. Professor Mikesell points out that the Texas margin tax is not included in his paper on gross receipts tax because it is more characteristic of a business profits tax than a gross receipts tax. *Id.*

[95] *Tax Reform in Texas: Lowering Business Costs, Expanding the Economy*, THE BEACON HILL INSTITUTE 3–4 (Nov. 2012), http://www.beaconhill.org/BHIStudies/TexasFranchise/TXFranchiseTaxReportFinal2.pdf.

[96] *See supra* notes 66, 68 and accompanying text.

[97] *See* HAMILTON ET AL., *supra* note 2, at § 4.4 ("[T]he treatment of . . . LLCs under the Texas franchise tax differs sharply from their treatment under the Internal Revenue Code. The federal 'check -the -box' regulation authorizes . . . LLCs with two or more members to elect to be taxed either as partnerships under subchapter K or as C or S corporations. Thus, . . . limited liability companies . . . are treated quite differently [under the Internal Revenue Code and] under the Texas franchise tax. The very popular single member LLC . . . is [taxed] as a 'nothing' [under Federal law] but is [fully] subject to the Texas franchise tax." (footnote omitted)). *Accord* Ohlenforst et al., *supra* note 2, at 1321 ("Significantly, limited liability companies that are disregarded and treated as sole proprietorships for federal income tax purposes are not treated as exempt sole proprietorships for margin tax purposes.").

[98] *See* TEX. BUS. ORGS. CODE ANN. §§ 1.002(14), (46) & 301.003(2) (West 2015).

[99] TEX. CONST. art. VIII, § 24(a).

[100] *See supra* notes 76–97 and accompanying text.

[101] When an entity owned by a natural person is taxed as a disregarded entity for federal income tax purposes, all of the entity's income is attributable to the entity's owner and reported on the owner's personal federal income tax return. *See* Treas. Reg. §§ 301.7701-1(a)(1), -2(a)–(c), -3(a)–(c). Since the entity's income is entirely attributable to and reportable by the entity's owner, it can be argued that a tax imposed by a state on the income of the entity operates in exactly the same manner as a tax imposed on the income of the owner.

[102] The term "flow-through" entity (also sometimes referred to as a "pass-through" entity) describes the tax treatment of an entity whereby income from the entity flows through to the owner(s) and tax on the entity's income is imposed directly on its owner(s). Generally speaking, in the case of a flow-through entity, the entity's income is not

a recent report ranking the business tax climate of the fifty states.[103] In the report, states that do not have an individual income tax were typically assigned a perfect score in the "Individual Income Tax" category.[104] Since Texas does not have an individual income tax, one would expect Texas to receive a perfect score in the Individual Income Tax category.[105] However, in contrast to other states that do not have an individual income tax, Texas did not receive a perfect score in the Individual Income Tax category.[106] One of the report's authors explained that the reason for this is structure of the margin tax and the fact that it is imposed on flow-through entities.[107] Texas received a lower score than other states that do not have an individual income tax because of the individual-income-tax nature of the margin tax when it is imposed on flow-through entities owned by natural persons.[108]

B. *Nestlé*

A few months after the *Allcat* petition was filed, another constitutional challenge was brought to the Texas Supreme Court by Nestlé USA, Inc., Switchplace, LLC, and NSMBA, LP.[109] Due to some procedural hiccups leading up to the filing of the case, the case was dismissed for want of jurisdiction.[110] After following correct procedural steps,[111] Nestlé USA, Inc. (Nestlé) re-filed its case with the Texas Supreme Court.[112]

Nestlé is a Delaware Corporation that, along with thirty-two affiliates, manufactures and distributes food and beverages in the United States.[113] Nestlé and its thirty-two affiliates are required to report as a combined group for purposes of the margin tax.[114] Generally speaking, an entity subject to the margin tax can choose to deduct either cost of goods sold or compensation from its total revenue.[115] As a combined group, Nestlé and its affiliates were all required to choose the same method for the entire group—either the cost of goods sold deduction or the compensation deduction—even if it resulted in no deduction being allowed

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recognized at the entity level. Instead, it is recognized by the entity's owner(s). *See* I.R.C. § 1366.

103 *See* Walczak, et al., *supra* note 48, at 29.

104 *See id.* (explaining that "[s]tates that do not impose an individual income tax generally receive a perfect score" in the Individual Income Tax Component of the report).

105 *See id.*

106 *See id.* at 28–29.

107 *See id.* at 29, 31, 33; *see also* Drenkard, *supra* note 6, at 11 (explaining that "the Margin Tax hurts the state's score in the individual income tax component of the Index as well (the state ranks 6th, instead of a perfect ranking of 1st), because the Margin Tax applies to S corporations and LLCs.").

108 *See id; but see* Keating, *supra* note 48, at 5 (where Texas received a perfect score in the personal income tax category).

109 *See generally In re* Nestle USA, Inc., 359 S.W.3d 207 (Tex. 2012).

110 *See id.* at 209, 212 (dismissing the case because the petitioners had failed to pay their taxes under protest or request a refund from the Comptroller as required by the Texas Tax Code prior to bringing the case to the Texas Supreme Court).

111 *See* Relator's Petition at 5, *In re* Nestle USA, Inc., 387 S.W.3d 610 (Tex. 2012) (No. 12-0518), 2012 WL 3233215.

112 *See generally In re Nestle*, 387 S.W.3d 610.

113 *See* Relator's Petition, *supra* note 111, at 4 and app. 6.

114 Relator's Petition, *supra* note 111, at 4.

115 *See* TEX. TAX CODE ANN. § 171.101(a)(1)(B)(ii) (West 2015). Alternatively, an entity can deduct a flat 30 percent from its total revenue using the EZ Computation method. *See id.* § 171.101(a)(1)(A)(i).

for some entities in the group.[116]

As a company, Nestlé engages in manufacturing, wholesale, and retail activities throughout the United States. However, since none of Nestlé's manufacturing facilities are located in Texas, it conducts only wholesale and retail activities in Texas.[117] Retailers and wholesalers are taxed differently than manufacturers under the margin tax. Under the laws in effect at the time of the *Nestle* case, the rate of the margin tax was one-half percent of an entity's taxable margin for entities primarily engaged in retail or wholesale trade and one percent of an entity's taxable margin for all other types of businesses.[118] So, businesses engaged primarily in retailing or wholesaling were taxed at a lower rate than businesses engaged primarily in manufacturing. Nestlé and its affiliates do not conduct any manufacturing activities in Texas.[119] However, for purposes of the margin tax, Nestlé's manufacturing activities that take place outside of Texas are taken into account when determining whether Nestlé is subject to the half-percent retailer/wholesaler rate or the one-percent manufacturer rate.[120]

For the reasons described above, as well as other components of the margin tax that Nestlé viewed as being arbitrary among taxpayers and not reasonably related to the privilege of doing business in Texas, Nestlé asserted that the margin tax is unconstitutional on four grounds.[121] First, Nestlé contended that the margin tax violates the Equal and Uniform Taxation clause of the Texas Constitution[122] because "it taxes taxpayers disparately based on classifications that have no reasonable relationship to the value of the privilege of doing business in Texas."[123] Second, Nestlé asserted that the margin tax violates the Fourteenth Amendment's Equal Protection Clause by treating similarly-situated taxpayers differently in how the tax base is calculated and in how the tax rate is applied, with such differences having no rational basis and insufficient relationship to the value of the privilege of doing business in Texas.[124] Third, Nestlé argued that the margin tax violates the Fourteenth Amendment's Due Process Clause by imposing a higher tax rate on entities that are classified as "manufacturers" based solely on manufacturing activities that take place outside of Texas than on entities classified as "wholesalers" and "retailers," with no difference in the benefits received from Texas by the higher-taxed entities classified as "manufacturers."[125] Finally, Nestlé claimed that the margin tax violates the dormant Commerce Clause because it discriminates against interstate commerce and is not fairly related to the services provided by Texas.[126]

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[116] Relator's Petition, *supra* note 111, at 9. *See also*, TAX. § 171.1014.

[117] *See* Relator's Petition, *supra* note 111, at 4–5.

[118] *Id.* at 4; *see* TAX § 171.002(a)–(b).

[119] Relator's Petition, *supra* note 111.

[120] *See* TAX §§ 171.1012, 171.1014; Relator's Petition, *supra* note 111, at 15.

[121] *See In re* Nestle USA, Inc., 387 S.W.3d 610, 612 (Tex. 2012).

[122] TEX. CONST. art. VIII, § 1(a).

[123] Relator's Petition, *supra* note 111.

[124] *Id.* at 13.

[125] *Id.* at 14.

[126] *Id.* at 15.

1. Equal and Uniform Taxation Clause of the Texas Constitution

Nestlé was unsuccessful on all four assertions. As for Nestlé's first argument, the Court pointed out that the Equal and Uniform Taxation clause requires "only that taxation—not taxes—must be equal and uniform, indicating that it is the process, not each individual result, that must satisfy the requirement."[127] In addition, the Court said, "It is important to note that classifying taxpayers for purposes of an occupation tax is not an exception to the Equal and Uniform Clause but a consequence of it."[128] Holding that the margin tax does not violate the Equal and Uniform Clause of the Texas Constitution, the Court concluded that the margin tax's classifications are permitted under the Clause and that the structure of the tax is reasonably related to the value of the privilege of doing business in Texas.[129]

2. Fourteenth Amendment's Equal Protection Clause

The Court held that, since Nestlé fell short of establishing the elements for a successful Equal and Uniform Taxation challenge, its second argument based on Equal Protection necessarily failed because the Equal and Uniform Clause of the Texas Constitution places a stricter standard on a state's tax laws than the Equal Protection Clause of the Fourteenth Amendment does.[130]

3. Fourteenth Amendment's Due Process Clause

Next, the Court quickly dispensed with Nestlé's third argument based on Due Process by citing to a 1939 United States Supreme Court case involving the Texas franchise tax, which held that "the franchise tax did not violate due process because in 'a unitary enterprise, property outside the state, when correlated in use with property within the state, necessarily affects the worth of the privilege within the state.'"[131]

4. Dormant Commerce Clause

The Court delivered the final nail in the coffin by rejecting Nestlé's fourth argument based on the dormant Commerce Clause. In response to Nestlé's claim that the margin tax discriminates against interstate commerce because its tax rates are based on an entity's non-Texas activities (such as when an entity is taxed at the higher manufacturer rate due to its manufacturing activities that occur entirely outside of Texas), the Court explained that "[t]axes do not discriminate when the differing rate stems 'solely from differences between the nature of their businesses, not from the location of their activities.'"[132] The Court concluded that, because the margin tax's rates are based on an entity's activities and not on the location of those activities, the rates do not discriminate against interstate commerce.[133] Responding to

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127 *In re* Nestle USA, Inc., 387 S.W.3d 610, 618 (Tex. 2012).

128 *Id.* at 620.

129 *Id.* at 621–24.

130 *See id.* at 624.

131 *Id.* (quoting Ford Motor Co. v. Beauchamp, 308 U.S. 331, 336 (1939)).

132 *Id.* at 625 (quoting Amerada Hess Corp. v. Dir., Div. of Taxation, N.J. Dep't of Treasury, 490 U.S. 66, 78 (1989)).

133 *See id.*

Nestlé's claim that the margin tax is not fairly related to the services provided by Texas, the Court reasoned that "the franchise tax need not precisely align the tax rate with the value of the Privilege [of doing business in Texas]. It is enough that manufacturing outside of the state will often increase the value of doing business within the state."[134]

V. SIGNIFICANT LOWER-COURT CASES

Although *Allcat* and *Nestle* removed some major hurdles faced by those seeking to implement and enforce the margin tax, seemingly endless challenges still remain.[135] Some significant cases which have impacted the application of the margin tax are discussed next.[136]

A. Can "Net Gain" Be a Negative Number?

As discussed briefly in Section B, *supra*, the margin tax is calculated by applying the appropriate tax rate to an entity's taxable margin.[137] The taxable margin of an entity that does business in multiple states is generally computed by multiplying the entity's margin[138] by the statutory apportionment factor.[139] The apportionment factor is "a fraction, the numerator of which is the taxable entity's gross receipts from business done in [Texas] . . . and the denominator of which is the taxable entity's gross receipts from its entire business."[140] Put simply, the numerator of the apportionment factor is the entity's gross receipts attributable to its activities in Texas, and the denominator of the apportionment factor is the entity's total receipts from its entire business, sometimes referred to as "everywhere receipts."[141] The following is a demonstration of the basic calculation of entity's tax liability using the apportionment factor from Section 171.106 of the Texas Tax Code:

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134 *Id.*

135 *See* Haney & Wright, *supra* note 14, at 1 (referencing the "countless lower court decisions and administrative hearings" that have stemmed from the margin tax).

136 There have been many other significant cases in addition to those examined in this article, including those dealing with the flow-through problem, *see, e.g.,* Titan Transp., L.P. v. Combs, 433 S.W.3d 625 (Tex. App.—Austin 2014, pet. denied); Allcat Claims Serv., L.P. v. Combs, No. D-1-GN-11-002294 (201st Dist. Ct., Travis County, Tex. Aug. 1, 2011); and those clarifying which types of businesses qualify for the lower retail tax rate, *see, e.g.*, Rent-A-Ctr., Inc. v. Hegar, 468 S.W.3d 220 (Tex. App.—Austin 2015, no pet.), to name but a few. In addition, the discussion below does not address thorny nexus issues, which are outside the scope of this Article.

137 *See* TEX. TAX CODE ANN. § 171.002(a)–(b) (West 2015). For 2016, the tax rate is .375 % for retailers and wholesalers and .75 % for all other businesses.

138 *See supra* notes 24–33 and accompanying text for the basic calculation of an entity's margin.

139 *See* TAX § 171.101(a)(2).

140 *Id.* § 171.106(a).

141 Upjohn Co. v. Rylander, 38 S.W.3d 600, 604 n.5 (Tex. App.—Austin 2000, pet. denied) (explaining that "Texas uses an apportionment formula in the form of a fraction to calculate a corporation's Texas business as follows: Texas receipts/Everywhere receipts."); *see also Franchise Tax Frequently Asked Questions: Apportionment*, TEX. COMPTROLLER OF PUB. ACCOUNTS, https://www.comptroller.texas.gov/taxes/franchise/ (last visited Oct. 25, 2016) (explaining that the apportionment factor is calculated "by dividing Texas Gross Receipts by Everywhere Gross Receipts").

Margin[142] x	Texas receipts[143] / Everywhere receipts[144]	=Taxable Margin[145] x	Tax Rate[146]	=Tax Liability[147]

The denominator of the factor (i.e., an entity's "everywhere receipts") includes receipts from the sale of tangible personal property, receipts from services, rentals, and royalties, and receipts from other business.[148] However, the sale of an investment or capital asset by the entity is treated differently.[149] According to the statute, "[i]f a taxable entity sells an investment or capital asset, the taxable entity's gross receipts from its entire business for taxable margin includes only the net gain from the sale."[150] The interpretation of this statutory exception is at the heart of a case that was recently decided by the Texas Supreme Court.[151]

In *Hallmark Mktg. Co., LLC v. Combs*, the taxpayer was a company with nationwide retail activities.[152] The taxpayer was subject to the margin tax due to its business activities in Texas.[153] The taxpayer had substantial gross receipts from its business activities, but recognized huge losses in the sale of investments and capital assets during the year that was the subject of the case.[154] To calculate the denominator of the apportionment factor, the taxpayer added up its gross receipts from its business activities.[155] The taxpayer did not subtract its investment and capital losses from the denominator because the statute directs "that 'only the net *gain* from the sale' of investment or capital assets are included" in the denominator.[156] The taxpayer reasoned that, since its investment and capital transactions resulted in a loss rather than a gain, the resulting negative number should not be included in the denominator.[157]

The Texas comptroller disagreed with the taxpayer's interpretation of the statute.[158] The

142 *See supra* notes 24–30 and accompanying text.
143 *See* TAX § 171.106(a).
144 *See id.*; *see also id.* § 171.105.
145 *See supra* note 31 and accompanying text.
146 *See supra* notes 32–33 and accompanying text.
147 *See id.*
148 *See* TAX § 171.105(a).
149 *See id.* at (b).
150 *Id.*
151 *See generally* Hallmark Mktg. Co. v. Combs, No. 13-14-00093-CV, 2014 WL 6090574 (Tex. App.—Corpus Christi Nov. 13, 2014), *rev'd sub nom.* Hallmark Mktg. Co. v. Hegar, No. 14-1075, 2016 WL 1516774 (Tex. Apr. 15, 2016).
152 *See id.*
153 "A franchise tax is imposed on each taxable entity that does business in this state." TAX § 171.001(a).
154 *Hallmark Mktg. Co.*, 2014 WL 6090574, at *3 (noting that in 2008 Hallmark had gross receipts totaling more than $4.5 billion and capital losses of more than $600 million).
155 *Id.*
156 *Id.*
157 *Id.*
158 *Id.*

comptroller's calculation of the denominator of the taxpayer's apportionment factor was quite different from the taxpayer's. In computing the denominator of the taxpayer's apportionment factor, the comptroller added up the taxpayer's gross receipts from business activities and then *subtracted* the taxpayer's huge investment and capital losses.[159]

Because the comptroller subtracted the investment and capital losses from the denominator of the apportionment factor, making the number in the denominator smaller than the number that the taxpayer had used for the denominator, the resulting fraction was larger than the fraction used by the taxpayer in determining its apportionment factor.[160] As a result of the higher apportionment factor under the comptroller's interpretation of the statute, the taxpayer owed more franchise tax than the taxpayer had originally calculated and a deficiency was assessed.[161]

The district court granted summary judgment in favor of the comptroller.[162] On appeal, the taxpayer argued (among other things) that the investment and capital losses should not be subtracted from the denominator of the apportionment factor because the plain language of the statute provides that "only the net gain" from the sale of investments or capital assets is included in the denominator of the apportionment factor.[163] The taxpayer reasoned that the ordinary meaning of the word "only" as used in the statute operates to "exclude its net loss, which is not a net gain, from the denominator" of the apportionment factor.[164]

While the taxpayer's plain-language argument primarily focused on four crucial words in the statute ("only the net gain"), the comptroller's position was based on a broader view of the statute in relation to the tax code as a whole, the intent of the legislature, rules adopted by the comptroller, and general consistency in the application of the tax laws.[165] For example, the comptroller argued that, because taxpayers are required to include investment and capital losses in "total revenue from entire business" under Section 171.1011 of the Texas Tax Code, taxpayers are also required to include those losses in "gross receipts from entire business" under Section 171.104.[166] Reasoning that "[n]othing in the statute requires a net gain to be positive,"[167] the comptroller pointed to a Texas case and a Wisconsin apportionment statute for support.[168] Perhaps most convincing to the appellate court was the comptroller's reference to a Comptroller Rule pertaining to apportionment which states that "net gains and losses from

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159 *See id.*

160 *See id.* (comparing the apportionment factor calculated by the comptroller (6.49%) to the apportionment factor originally calculated by the taxpayer (5.54%)).

161 *Id.* at *1, *3.

162 *See id.* at *1.

163 *See* Appellant's Brief at *4, *6, *Hallmark Mktg. Co.*, 2014 WL 6090574 (No. 13-14-00093-CV); TEX. TAX CODE ANN. § 171.105(b) (West 2015).

164 Appellant's Brief, *supra* note 163, at *9.

165 *See* Appellees' Brief at *4–5, *7–14, *Hallmark Mktg. Co.*, 2014 WL 6090574 (No. 13-14-00093-CV).

166 *Id.* at *7–9.

167 *Id.* at *10.

168 *See id.* at *10–12 (citing Calvert v. Electro-Sci. Inv'rs, Inc., 509 S.W.2d 700, 702 (Tex. Civ. App.—Austin 1974, no writ) and WIS. STAT. ANN. § 71.45(2)(b)(l) (West 2015)). The comptroller also pointed to a recent 7th Circuit Posner opinion, which suggested that "net gain" could be a negative number in some situations. *See In re* Fort Wayne Telsat, Inc., 665 F.3d 816, 821, 823 (7th Cir. 2011).

sales of investments and capital assets must be added to determine the total gross receipts from such transactions. . . . If the combination of net gains and losses results in a net loss, the taxable entity should net the loss against other receipts, but not below zero."[169]

In affirming the district court's judgment in favor of the comptroller, the Thirteenth Court of Appeals[170] found that "tax code section 171.105(b) is ambiguous but . . . Rule 3.591 is a reasonable construction of the statute and is in accord with the statute's plain language."[171]

Upon grant of review by the Texas Supreme Court, the taxpayer asserted that the Comptroller Rule is not entitled to deference because it conflicts with the unambiguous language of Section 171.105(b) of the Texas Tax Code.[172] The taxpayer contended that the portion of Comptroller's Rule 3.591 stating that a net loss from sales of investments and capital assets should offset other receipts to determine total gross receipts conflicts with the plain language of Section 171.105(b) of the Texas Tax Code, which states that "gross receipts . . . includes only the net gain from the sale" of investments and capital assets.[173]

In contrast to the taxpayer's interpretation of the statute, the comptroller argued that, because the statute's phrase "net gain" is "subject to multiple understandings," deference should be given to the comptroller's interpretation of this phrase in Rule 3.591.[174] Alternatively, the comptroller suggested that the word "only" as used in the statute is meant to modify the word "net" and not the word "gain," with the phrase being spoken aloud as follows: includes only *net* gain.[175] In other words, the purpose of the word "only" in the statute is to distinguish "gain" from "net gain," and clarify that net gain—not the entire gain prior to deducting basis, expense of sale, etc.—from the sale of investments and capital assets will be included in the denominator of the apportionment fraction.[176]

The comptroller also argued that "account[ing] for [the taxpayer's] loss in determining its 'taxable margin' but not when calculating its apportionment fraction artificially inflates the denominator in the apportionment formula which is intended to reasonably represent the proportion of business conducted everywhere."[177] Along those same lines, the comptroller reasoned that "if an entity takes a loss into consideration when calculating its total revenue under section 171.1011, it must also account for that loss when calculating its apportioned margin under section 171.105."[178] In addition, the comptroller asserted that, reading the statute

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[169] TEX. ADMIN. CODE ANN. tit. 28, § 3.591 (West 2016).

[170] The case was transferred from the Third Court of Appeals by order of the Texas Supreme Court for docket equalization. *See Hallmark Mktg. Co.*, 2014 WL 6090574, at *1 n.1 (citing TEX. GOV'T CODE ANN. § 73.001 (West 2015)).

[171] *Hallmark Mktg. Co.*, 2014 WL 6090574, at *4–5.

[172] *See* Petitioner's Brief on the Merits at *22–24, Hallmark Mktg. Co., LLC v. Hegar, 488 S.W.3d 795 (Tex. 2016) (No. 14-1075).

[173] *Id.*; TEX. TAX CODE ANN. § 171.105(b) (West 2015).

[174] Response to Petition for Review at *13, *Hallmark Mktg. Co., LLC*, 488 S.W.3d 795 (No. 14-1075).

[175] Oral arguments in the Texas Supreme Court, Dec. 9, 2015, http://www.search.txcourts.gov/Case.aspx?cn=14-1075&coa=cossup (last visited Nov. 7, 2016).

[176] *Id.*

[177] Response to Petition for Review, *supra* note 174, at *17.

[178] *Id.* at *3.

in the context of other relevant portions of the tax code and considering the intent of the legislature, the taxpayer should be required to subtract the losses from the sale of investments and capital assets from the denominator of the apportionment fraction.[179]

On April 15, 2016, the Texas Supreme Court reversed the Thirteenth Court of Appeals, holding that the phrase "only the net gain" found in Section 171.105(b) of the Texas Tax Code "necessarily excludes a net loss."[180] Addressing the appellate court's finding that the phrase "net gain" is ambiguous, the Texas Supreme Court explained that the issue of whether the phrase "net gain" is ambiguous is irrelevant in the *Hallmark* case because the taxpayer in *Hallmark* "suffered only a net *loss*."[181] The Court further stated that "[t]he statute requires inclusion of 'only the net gain,' and under no reading can 'net gain' include a net loss." Accordingly, we cannot defer to the comptroller's rule requiring inclusion of a net loss in Hallmark's apportionment-factor denominator because it conflicts with the plain language of Tax Code section 171.105(b)."[182]

Along with other issues raised by the parties, the Court disposed of the comptroller's argument that the phrase "'net gain' can be read expansively enough to include a net loss."[183] Reading the phrase "net gain" to include a net loss, said the Court, would impermissibly "add to the statute's plain language" and "effectively write the word 'only' out of the statute."[184]

The Court also rejected the comptroller's claim that other sections of the Texas Tax Code, when examined in concert, require that net losses from the sale of investments and capital assets be included in the denominator of the apportionment factor.[185] In doing so, the Court explained that Section 171.105(b) pertains to a "specific issue—what to do with the proceeds from the sale of an investment when calculating the apportionment-factor denominator—and lays out a clear rule: include 'only the net gain from the sale.'"[186] The Court acknowledged that, if there were a conflict among Section 171.105(b) and the other more general sections of the Tax Code referenced by the comptroller, the more specific section (i.e., Section 171.105(b)) would control.[187] However, the Court observed that, since the general statutes cited by the comptroller did not conflict with Section 171.105(b)'s "only net gain" provision, the general statutes have no impact on Section 171.105(b).[188] Therefore, Section 171.105(b) "means just what it says—'only the net gain from the sale' of investments should be included in the apportionment-factor denominator."[189]

In summary, the parties in *Hallmark* considered the following question: Can "net gain" ever be a negative number in the context of the "everywhere receipts" component of the Texas

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179 *Id.* at *6–7.
180 Hallmark Mktg. Co., LLC v. Hegar, 488 S.W.3d 795 (Tex. 2016).
181 *Id.* at 799.
182 *Id.* at 799–800.
183 *Id.* at 799.
184 *Id.*
185 *Id.* at 800.
186 *Id.*
187 *See id.*
188 *Id.*
189 *Id.* at 801.

franchise tax apportionment factor?[190] According to the Texas Supreme Court, "the answer is obvious and easy: No."[191]

B. If It Walks Like a Duck and Quacks Like a Duck . . .

Is the margin tax an "income tax"?[192] Some commentators believe the margin tax falls within the general definition of an income tax.[193] As discussed previously, the Texas Supreme Court declined to address this question in the *Allcat* case,[194] but the issue has again come to the forefront in a recent apportionment case.[195]

In *Graphic Packaging Corporation v. Hegar*, the taxpayer was a Georgia corporation that sold packaging products nationwide, including within the borders of Texas.[196] Because the taxpayer engaged in retail and wholesale activities in Texas, the taxpayer was subject to the margin tax.[197]

As discussed earlier in this Article, the margin tax liability for an entity that does business in multiple states is determined in part by applying an apportionment factor (to account for the entity's business activities in Texas) to the entity's margin to arrive at the entity's taxable margin.[198] However, rather than use the "single-factor" [199] apportionment formula set forth in Chapter 171 of the Texas Tax Code (the "Franchise Tax" formula) discussed above in Section A to determine taxable margin, the taxpayer in *Graphic* used the "three-factor"[200] apportionment formula found in Chapter 141 of the Texas Tax Code (the "Multistate Tax Compact" formula).[201]

Before looking at the taxpayer's rationale for using the Multistate Tax Compact three-factor apportionment formula rather than the Franchise Tax single-factor apportionment formula, a comparison of the two formulas is helpful. The Franchise Tax apportionment formula divides a taxpayer's gross receipts from business done in Texas by a taxpayer's gross

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190 Or, as the Court put it, "can net gain sometimes mean net loss if losses outstrip gains?" *Id.* at 799.

191 *Id.* (stating that "[h]owever net gain is calculated, a statutory net gain cannot simultaneously be a net loss").

192 It is sometimes incorrectly stated that the Texas Constitution prohibits a state income tax (absent voter approval). However, the Texas Constitution's prohibition applies only to an income tax on natural persons. *See* TEX. CONST. art. VIII, § 24(a) (prohibiting a tax (absent voter approval) on the "net incomes of natural persons, including a person's share of partnership and unincorporated association income"). Contrary to the perception of some, the Texas Constitution's prohibition on a state income tax does not apply to the taxation of business entities. Therefore, a state income tax on businesses is not prohibited by the Texas Constitution. *See id.*

193 See *supra* notes 76–95 and accompanying text.

194 *See supra* notes 64–68 and accompanying text.

195 *See generally* Graphic Packaging Corp. v. Hegar, 471 S.W.3d 138 (Tex. App.—Austin 2015, pet. filed). For a similar case pending in the Third Court of Appeals at the time of publication, see *EMC Corp. v. Hegar,* No. D-1-GN-14-000851 (353 Dist. Ct., Travis County, Tex. Feb 18, 2015), *appeal docketed*, No. 03-15-00113-CV, 2016 WL 4269975 (Tex. App.—Austin 2016).

196 *Graphic Packaging Corp*., 471 S.W.3d at 139.

197 *See* TEX. TAX CODE ANN. § 171.001(a) (West 2015).

198 *See supra* notes 137– 147 and accompanying text.

199 *See Graphic Packaging Corp.*, 471 S.W.3d at140; *see also* TAX § 171.106.

200 *Id.*

201 *Id.*; *see* TAX § 141.001.

receipts from all sources everywhere.[202] It considers only one aspect of the taxpayer's business activities—gross receipts—hence, the "single-factor" label.[203] It does not incorporate any other aspects of the entity's business activities that may be relevant to a fair apportionment of the entity's tax liability among Texas and other states in which the entity does business.[204]

In contrast, the Multistate Tax Compact formula takes three business activities into account in its calculation.[205] In addition to accounting for an entity's Texas sales in relation to the entity's total sales occurring everywhere[206] as is accounted for in the Franchise Tax formula, the Multistate Tax Compact formula accounts for an entity's ownership or use of property in Texas in relation to the entity's ownership or use of property everywhere,[207] as well as the amount of payroll that the entity pays in Texas in relation to the total amount of payroll that the entity pays everywhere.[208] Following is a very basic example comparing the Franchise Tax single-factor apportionment formula with the Multistate Tax Compact three-factor apportionment formula:

Franchise Tax (Chapter 171)
Single-Factor Apportionment Formula[209]

$$\frac{\text{Texas receipts}}{\text{Everywhere receipts}}$$

Multistate Tax Compact (Chapter 141)
Three-Factor Apportionment Formula[210]

$$\frac{\frac{\text{Texas Property}}{\text{All Property}} + \frac{\text{Texas Payroll}}{\text{All Payroll}} + \frac{\text{Texas Sales}}{\text{All Sales}}}{3}$$

In *Graphic*, it was desirable for the taxpayer to use the Multistate Tax Compact three-factor formula because it produced a more favorable result for the taxpayer than using the Franchise Tax single-factor formula.[211] The three-factor formula produced a more favorable result because the taxpayer engaged in retail and wholesale activities in Texas, but it did not conduct any manufacturing activities in Texas.[212] Since the *Graphic* taxpayer did not own or

[202] *See* TAX §§ 171.106(a), 171.103, 171.105.

[203] *See Graphic Packaging Corp.*, 471 S.W.3d at 140.

[204] *See* ETC Mktg., Ltd. v. Harris Cty Appraisal Dist., 476 S.W.3d 501, 511 (Tex. App.—Houston [1st Dist.] 2015, pet. filed) (explaining that the "central purpose behind the apportionment requirement is to ensure that each State taxes only its fair share of an interstate transaction"); *see also* Home Interiors & Gifts, Inc. v. Strayhorn, 175 S.W.3d 856, 863 (Tex. App.—Austin 2005, pet. denied) (noting that the "fair apportionment requirement attempts to ensure that no State taxes more than its fair share of an interstate transaction").

[205] "All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three." TAX § 141.001, art. IV.9.

[206] *Id.* at art. IV.15.

[207] *Id.* at art. IV.10.

[208] *Id.* at art. IV.13.

[209] *Id.* § 171.106.

[210] *Id*. § 141.001, arts. IV.9, IV.10, IV.13, IV.15.

[211] Graphic Packaging Corp. v. Hegar, 471 S.W.3d 138, 140 (Tex. App.—Austin 2015, pet. filed).

[212] *Id.*

operate any manufacturing facilities in Texas, using the three-factor formula, which equally weighs factors for a taxpayer's Texas property (which was zero for the *Graphic* taxpayer) and a taxpayer's Texas Payroll (which was zero for the *Graphic* taxpayer) with a taxpayer's Texas Sales, produced a lower tax liability than the single-factor formula, which calculates the tax liability based only on Texas receipts and does not take into account a taxpayer's Texas property or Texas payroll.[213]

The *Graphic* taxpayer based its use of the three-factor formula on the premise that the margin tax constitutes an "income tax" on businesses as defined in the Multistate Tax Compact.[214] Under the Multistate Tax Compact, a business entity that is subject to a state income tax in multiple states can choose to apportion its income either in accordance with the laws of the taxing state or by using the three-factor Multistate Tax Compact formula.[215] The Multistate Tax Compact defines "income tax" as "a tax imposed on or measured by net income including any tax imposed on or measured by an amount arrived at by deducting expenses from gross income, one or more forms of which expenses are not specifically and directly related to particular transactions."[216]Concluding that the margin tax constitutes an "income tax" for purposes of the Multistate Tax Compact, the *Graphic* taxpayer chose to use the Multistate Tax Compact apportionment formula rather than the formula found in the Franchise Tax chapter of the Texas Tax Code.[217]

The Texas comptroller did not agree with the taxpayer's position and denied the taxpayer's use of the Multistate Tax Compact's apportionment formula.[218] In district court, the comptroller won its motion for summary judgment on the issue of whether the taxpayer properly elected to use the Multistate Tax Compact's apportionment formula rather than the apportionment formula set forth in the Franchise Tax chapter of the Texas Tax Code.[219] On appeal, the crux of the case was whether the margin tax falls within the Multistate Tax Compact's definition of "income tax."[220]

One of the taxpayer's arguments was that the margin tax falls within the meaning of "income tax" found in the Multistate Tax Compact when a taxpayer uses the cost-of-goods-sold method to calculate its margin tax liability (as the taxpayer did in this case) "because a taxpayer may determine its tax base (its margin) . . . by subtracting its cost of goods sold, including indirect costs, and those indirect costs are 'expenses' that are 'not specifically or

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213 *Id.*; *compare* TAX § 141.001 *with* TAX § 171.106.

214 *Graphic Packaging Corp.*, 471 S.W.3d at 141–42.

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> Any taxpayer subject to an income tax whose income is subject to apportionment and allocation for tax purposes pursuant to the laws of a party state or pursuant to the laws of subdivisions in two or more party states may elect to apportion and allocate his income in the manner provided by the laws of such state or by the laws of such states and subdivisions without reference to this compact, or may elect to apportion and allocate in accordance with Article IV.

TAX § 141.001, art. III.1.

216 *Id.* at art. II.4.

217 *Graphic Packaging Corp.*, 471 S.W.3d at 140, 142.

218 *Id.* at 140–41.

219 *Id.* at 141.

220 *Id.* at 143.

directly related to a particular transaction.'"[221] The taxpayer reasoned that, looking at the plain language of the Multistate Tax Compact's definition of "income tax," the margin tax clearly qualifies as an income tax "because its computation begins with gross receipts, which then are reduced by a myriad of exclusions and expense deductions, including indirect (overhead) expenses, at least some of which are not specifically and directly related to particular transactions"[222] Some examples of indirect expenses given by the taxpayer included utilities, insurance, and administrative expenses.[223]

In response, the comptroller argued (among other things) that the margin tax is not an income tax, observing that "[t]he Legislature made this distinction clear when it revised the franchise tax to its current form: 'The franchise tax imposed by Chapter 171, Tax Code, as amended by this Act, is *not an income tax*.'"[224] The comptroller also cited a case where the court defined net income as the "'excess of all revenues and gains for a period over all expenses and losses of the period'"[225] and pointed out that "'margin' never involves deducting 'all expenses and losses.'"[226] Because taxpayers do not deduct *all* expenses to arrive at the margin, the comptroller reasoned that the margin is not equivalent to net income.[227]

The Third Court of Appeals affirmed in favor of the comptroller, finding that the margin tax does not meet the Multistate Tax Compact's definition of "income tax."[228] The court's reasons included the fact that there are methods for determining margin other than deducting expenses from total revenue and, even when the margin is determined by deducting expenses under the cost-of-goods-sold or compensation methods, these methods only allow certain expenses to be deducted.[229] The court also noted that Section 171.106(a) of the Texas Tax

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221 *Id.* at 143–44.

222 Brief for Appellant at 50, 53, *Graphic Packaging Corp.*, 471 S.W.3d 138 (No. 03-14-00197-CV).

223 *Id.* at 52, 55.

224 Brief of Appellees at 21, *Graphic Packaging Corp.*, 471 S.W.3d 138 (No. 03-14-00197-CV) (quoting Act of May 2, 2006, 79th Leg., 3d C.S., ch. 1, § 21, 2006 Tex. Gen. Laws 1, 38). In contrast to the comptroller's reliance on the label give to the margin tax by the legislature, the Council on State Taxation observed in its amicus brief filed in this matter, "While the Texas Legislature can opine on whether the franchise tax is subject to that federal law, ultimately it is up to the courts to decide whether the franchise tax meets that definition." Brief of Council on State Taxation as Amicus Curiae Supporting Appellant at 14, *Graphic Packaging Corp.*, 471 S.W.3d 138 (No. 03-14-00197-CV).

225 INOVA Diagnostics, Inc. v. Strayhorn, 166 S.W.3d 394, 401 n.7 (Tex. App.—Austin 2005, pet. denied) (quoting BLACK'S LAW DICTIONARY 1040 (6th ed. 1990)).

226 Brief of Appellees, *supra* note 224, at 22.

227 *Id.* Query whether a distinction exists between subtracting "all expenses" from gross revenue (the standard on which the comptroller insists) and subtracting all *deductible* expenses under applicable state or federal law. Under the Internal Revenue Code, taxpayers are not allowed a deduction for *all* expenses—only certain expenses enumerated in the Code. Some types of expenses are required to be capitalized rather than deducted in the period they are incurred. Some valid business expenses may not be deducted in full (for example, business meals limited to 50-percent deduction, business travel expense limited to a deduction based on mileage despite the actual cost of the transportation, compensation paid to employees in excess of the amount the IRS considers to be "reasonable," etc.). Under the definition on which the comptroller relies, a taxpayer could subtract from gross revenue all of the taxpayer's expenses for which the Internal Revenue Code allows a deduction and still not meet the comptroller's definition of "net income" simply because federal law did not allow a deduction for all of the taxpayer's expenses!

228 *See Graphic Packaging Corp.*, 471 S.W.3d at 144–47.

229 *See id.* at 144.

Code expressly states that the Franchise Tax formula must be used "[e]xcept as provided by this section" and reasoned that, since the Multistate Tax Compact formula is not listed as an alternative in Section 171.106, it is not a permissible alternative.[230] In addition, the court pointed to the statement made by the legislature at the time the margin tax was enacted: "'[T]he franchise tax imposed by Chapter 171, Tax Code, as amended by this Act, is not an income tax.'"[231]

The taxpayer's petition for review in the Texas Supreme Court is pending as of the time that this article is being published. Given the level of attention garnered by this case in the court below,[232] the impact of the Court's decision on the issues raised in this case will certainly extend beyond the *Graphic* taxpayer.[233]

C. Cost of Goods Sold

As mentioned in Section B, the margin tax is calculated by applying the relevant tax rate to an entity's taxable margin.[234] To calculate an entity's margin, the entity generally figures its "total revenue" and then deducts either its "compensation" expenses or its "cost of goods sold."[235] There have been numerous challenges relating to the Cost of Goods Sold (COGS) deduction.[236] What is a "good" for purposes of the COGS deduction? Who can take the COGS deduction? What is included in the COGS deduction? A few recent cases involving the COGS deduction are discussed next.

1. If You Can't Touch, Hold, or Feel It, Is It a "Good"?

Can a two-hour experience purchased by a customer qualify as a "good" for purposes of the COGS deduction? The Third Court of Appeals recently answered this question in the affirmative. In *American Multi-Cinema, Inc. v. Hegar,*[237] the taxpayer, which owned and

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230 *See id.* at 145. "Had the legislature intended for chapter 141's three-factor formula to be an alternative for apportioning margin for franchise tax purposes, it could have included it as one of the expressed alternatives in section 171.106." *Id.*

231 *Id.* at 146 (quoting Act of May 2, 2006, 79th Leg., 3d C.S., ch. 1, § 21, 2006 Tex. Gen. Laws 1, 38).

232 At least four amicus briefs were submitted to the Third Court of Appeals in this matter. *See* Brief of Council on State Taxation as Amicus Curiae Supporting Appellant, *Graphic Packaging Corp.*, 471 S.W.3d 138 (No. 03-14-00197-CV); Brief of the Interstate Commission for Juveniles, the Association of Compact Administrators of the Interstate Compact on the Placement of Children, and Jeffrey Litwak as Amici Curiae Supporting Appellant, *Graphic Packaging Corp.*, 471 S.W.3d 138 (No. 03-14-00197-CV); Brief of States of Oregon, Alaska, California, Colorado, Hawaii, Michigan, Minnesota, Montana, New Mexico, and Washington as Amici Curiae Supporting Appellees, *Graphic Packaging Corp.*, 471 S.W.3d 138 (No. 03-14-00197-CV); Brief of Multistate Tax Commission as Amici Curiae Supporting Appellees, *Graphic Packaging Corp.*, 471 S.W.3d 138 (No. 03-14-00197-CV).

233 *See* Brief of EMC Corporation as Amicus Curiae Supporting Petitioner at 1, *Graphic Packaging Corp.*, 471 S.W.3d 138 (No. 03-14-00197-CV), http://www.search.txcourts.gov/SearchMedia.aspx?MediaVersionID=f3080400-f587-49cd-9de3-c948a5393868&coa=cossup&DT=BRIEFS&MediaID=c08b1dfd-76e3-4c86-bbbb-6ed98054b6a7 (last visited Nov. 7, 2016).

234 *See* TEX. TAX CODE ANN. § 171.002(a)–(b) (West 2015).

235 *See supra* notes 25–31 and accompanying text for the basic calculation of an entity's margin.

236 *See* Titan Transp., L.P. v. Combs, 433 S.W.3d 625, 627–29 (Tex. App.—Austin 2014, pet. denied); Combs v. Newpark Res., Inc., 422 S.W.3d 46, 47–48 (Tex. App.—Austin 2013, no pet.).

237 *See generally* Am. Multi-Cinema, Inc. v. Hegar, No. 03-14-00397-CV, 2015 WL 1967877 (Tex. App.—

operated movie theaters, claimed the COGS deduction for its "costs of exhibiting films and other content (exhibition costs)" on its first two annual franchise tax returns filed under the new margin tax system.[238] On audit, the Texas comptroller disallowed the deduction of the taxpayer's exhibition costs on the grounds that the taxpayer does not sell "goods" for purposes of Texas Tax Code statutes pertaining to the deduction for cost of goods sold, resulting in a substantially higher franchise tax liability than originally calculated by the taxpayer.[239]

In district court, the primary issue in dispute was whether the taxpayer's exhibition of movies in theaters to its customers constitutes "goods" under the Texas franchise tax laws.[240] At a bench trial, the comptroller argued that the taxpayer's exhibition of movies in its theaters "does not fall within the meaning of 'tangible personal property' because it is either 'intangible property' or a movie-viewing 'service,'" both of which are expressly excluded from the definition of "tangible personal property" under the Texas Tax Code.[241] The comptroller reasoned that "[the taxpayer] does not sell the film, but the right to watch the film at a certain time and place."[242] As support for the taxpayer's position, the taxpayer pointed to the plain language of the statutory definition of tangible personal property ("personal property that can be seen . . . or that is perceptible to the senses in any other manner")[243] and argued that the movies shown in its theaters fall squarely within the definition because the movies can be seen and heard by customers (i.e., the movies are perceptible to the senses).[244]

The trial court found that when the taxpayer shows movies in its theaters, "it produces personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to

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Austin Apr. 30, 2015, no pet.) (mem. op).

[238] *Id.* at *1. The franchise reports at issue in this case were for tax years 2008 and 2009. *Id.* The controlling statute in this case was subsequently amended to allow movie theaters to claim the COGS deduction for exhibition costs. *See* Act of June 14, 2013, 83d Leg., R.S., ch. 1232, § 10, 2013 Tex. Sess. Law Serv. 3105, 3109 (current version at TAX § 171.1012(t)). Section 171.1012(t) of the Texas Tax Code now provides that

> [i]f a taxable entity that is a movie theater elects to subtract cost of goods sold, the cost of goods sold for the taxable entity shall be the costs described by this section in relation to the acquisition, production, exhibition, or use of a film or motion picture, including expenses for the right to use the film or motion picture.

TAX § 171.1012(t). While the amendment provides an avenue for movie theaters to claim the COGS deduction for exhibition costs, it does not expressly classify the exhibition of movies as "goods."

[239] *Am. Multi-Cinema, Inc.*, 2015 WL 1967877, at *1, *3.

[240] *Id.* at *1; Under the Texas Tax Code, "'Goods' means real or tangible personal property sold in the ordinary course of business of a taxable entity." TAX § 171.1012(a)(1). "Tangible personal property" is defined as:

> (i) personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner; and (ii) films, sound recordings, videotapes, live and prerecorded television and radio programs, books, and other similar property embodying words, ideas, concepts, images, or sound, without regard to the means or methods of distribution or the medium in which the property is embodied, for which, as costs are incurred in producing the property, it is intended or is reasonably likely that any medium in which the property is embodied will be mass-distributed by the creator or any one or more third parties in a form that is not substantially altered.

Id. at (a)(3)(A). "Tangible personal property" does not include intangible property or services. *Id.* at (a)(3)(B).

[241] *Am. Multi-Cinema, Inc.*, 2015 WL 1967877, at *5.

[242] *Id.*

[243] TAX § 171.1012(a)(3)(A)(i).

[244] *Am. Multi-Cinema, Inc.*, 2015 WL 1967877, at *5.

the senses in any other manner for sale in its ordinary course of business."[245] The trial concluded that this constituted the production of "goods for sale in the ordinary course of business under Section 171.1012, and [the taxpayer] may therefore include the costs of exhibiting movies and other content to its paying customers in its cost-of-goods-sold deduction under Section 171.1012 of the Texas Tax Code."[246]

On appeal, the comptroller argued that "exhibiting films does not constitute a 'good' because [the taxpayer] does not sell 'tangible personal property' but intangible property, or a film-watching service, or non-property."[247] The comptroller contended that the tickets purchased by the taxpayer's customers were merely licenses, pointing out that "[the taxpayer's] customers leave [the] theaters with experiences and memories but without a copy of the film."[248] Finding that the language of the statute that defines "goods" is not ambiguous, the Third Court of Appeals looked to the plain meaning of the statute.[249] The court observed that the statute "defines 'tangible personal property' broadly to mean 'personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner'" and that the definition of tangible personal property "does not have a take-home requirement."[250] The court also noted that the comptroller's characterization of the taxpayer's exhibition of movies as "intangible property" or "services" directly conflicts with portions of the statute.[251] Accordingly, the Third Court of Appeals concluded that the trial court did not err in ruling that the taxpayer was entitled to claim a COGS deduction for its exhibition costs and affirmed in favor of the taxpayer.[252]

The comptroller filed a motion for rehearing in the Third Court of Appeals,[253] and depending on the disposition of that motion, commentators predict this case may be headed to the Texas Supreme Court.[254] The outcome of this case could have broader implications than

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245 *Id.* at *4.

246 *Id.*

247 *Id*.

248 *Id*. at *5.

249 *Id.* at *4–5.

250 *Id.*

251 *Id.* at *6. The courted referred to the following portion of Section 171.1012 of the Texas Tax Code:

> 'Tangible personal property' means . . . films, sound recordings, videotapes, live and prerecorded television and radio programs, books, and other similar property embodying words, ideas, concepts, images, or sound, without regard to the means or methods of distribution or the medium in which the property is embodied, for which, as costs are incurred in producing the property, it is intended or is reasonably likely that any medium in which the property is embodied will be mass-distributed by the creator or any one or more third parties in a form that is not substantially altered.

TEX. TAX CODE ANN. § 171.1012(a)(3)(A)(ii) (West 2015).

252 *Am. Multi-Cinema, Inc.*, 2015 WL 1967877, at *6, *10.

253 *See* Appellees'/Cross-Appellants' Motion for Rehearing and for Reconsideration En Banc, *Am. Multi-Cinema, Inc.*, 2015 WL 1967877 (No. 03-14-00397-CV), http://www.search.txcourts.gov/SearchMedia.aspx?MediaVersionID=08c16541-ebea-442e-b2bd-a188f48dae7b&coa=coa03&DT=Motion&MediaID=dc7fd779-f237-4b9b-bbf9-74cdde282fa4 (last visited Nov. 7, 2016).

254 *See, e.g.,* Josh Haney, *Fiscal Notes: Franchise Tax Lawsuit Could Cost Texas $1.5 Billion a Year*, TEX. COMPTROLLER OF PUB. ACCOUNTS (June–July 2015), https://www.comptroller.texas.gov/economy/fiscal-notes/2015/june/amc-decision.php.

what first meets the eye. Beyond the impact that it would obviously have on movie theaters operating in Texas, the court's interpretation of the statutory definition of goods could be extended to a number of businesses traditionally considered to be in the service industry.[255] The Texas comptroller's office has estimated that such a result could put quite a dent in the state's margin tax revenue.[256] For now, all eyes are on the Third Court of Appeals to see whether the comptroller's request for rehearing will be granted.

2. Does Combined Group's COGS Deduction Include Service-Only Subsidiary's Costs?

When determining cost of goods sold for a combined group, is each affiliate's business considered in isolation or in the context of the combined group's business as a whole? This question was answered by the Third Court of Appeals in *Combs v. Newpark Resources, Inc*.[257] The taxpayer's primary business activity in *Newpark* involved the "manufacture, sale, injection, and removal of 'drilling mud,'" with the taxpayer's several subsidiaries providing various types of support operations, such as manufacturing, sales, and hazardous waste removal.[258] One of the subsidiaries engaged only in service-providing activities and did not sell any goods in the ordinary course of business.[259]

The taxpayer was required to file a single franchise tax return for itself and its subsidiaries as a combined group.[260] In preparing the report, the taxpayer had to select the same deduction (generally the choice is to deduct cost of goods sold or compensation) for the entire group.[261] The taxpayer chose the cost-of-goods-sold deduction for the combined group.[262] In doing so, the taxpayer included expenses incurred by its service-only subsidiary in the combined group's cost-of-goods-sold deduction, even though the subsidiary would not have qualified for the cost-of-goods-sold deduction if it were a stand-alone company.[263]

The Comptroller argued that, because the taxpayer's subsidiary provided only services and did not independently qualify for a cost-of-goods-sold deduction, the taxpayer was not allowed to include the subsidiary's expenses in the combined group's overall cost-of-goods-sold

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[255] *See id*. (positing that "[u]nder the Court of Appeals' interpretation, a clean house could be considered 'perceptible,' so housecleaning might be classified as tangible personal property").

[256] *See id*. (estimating that "the cumulative fiscal impact due to the expanded COGS deduction could rise to \$1.5 billion each year" and pointing out that since taxpayers can amend franchise tax returns for up to four years back, the state could be looking at refunds totaling \$6 billion).

[257] *See generally* Combs v. Newpark Res., Inc., 422 S.W.3d 46 (Tex. App.—Austin 2013, no pet.).

[258] *Id*. at 48.

[259] *Id*. at 50.

[260] *Id*. at 48.

[261] *Id.*; *see supra* notes 25–29 and accompanying text for a brief look at the cost-of-goods-sold and compensation deductions.

[262] *Newpark Res., Inc.*, 422 S.W.3d at 48–49.

[263] *Id.* at 49–51. Newpark included its subsidiary's expenses in the cost-of-goods-sold deduction on grounds that the subsidiary had furnished labor to a project for the construction or improvement of real property. *See id.* at 53–57; *see also* TEX. TAX CODE ANN.§ 171.1012(i) (West 2015). The taxpayer's inclusion of the subsidiary's expenses on this basis was challenged by the Comptroller, but the court held in favor of the taxpayer on this issue. *Newpark Res., Inc.*, 422 S.W.3d at 57.

deduction.[264] Ruling in favor of the taxpayer, the court noted that, according to the plain language of the statute, the determination of whether an entity that is a member of a combined group qualifies for the cost-of-goods-sold deduction must be made by viewing the combined group's activities as a whole and not the single entity's activities in isolation.[265]

3. What Exactly Can Be Included in COGS Deduction?

a. Labor or Materials Furnished to Project Involving Real Property

An entity that is not typically considered a manufacturer or seller of "goods" under the general definition of the statute may be able to claim a COGS deduction if the entity furnishes "labor or materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance . . . of real property."[266] In *Hegar v. CGG Veritas Services (U.S.), Inc.*, the taxpayer was a geoseismic company that acquired seismic data, processed the data to generate images of the subsurface of the earth, and sold sound recordings and images to oil and gas exploration and production companies.[267] On the taxpayer's initial franchise tax return filed under the new margin tax regime, the taxpayer claimed a COGS deduction of more than a half billion dollars.[268] The Texas comptroller disallowed the entire COGS deduction on the grounds that the taxpayer was a service provider.[269]

In district court, the taxpayer argued that it qualified for the COGS deduction because "the costs it included in calculating its COGS deduction were incurred exclusively for the 'construction, repair, or industrial maintenance of oil and gas wells, which are real property' and therefore includable in the COGS deduction pursuant to Tax Code subsection 171.1012(i)."[270] The comptroller maintained that the taxpayer "provides only services to oil and gas exploration and production companies and does not sell anything that meets the statutory definition of 'goods.'"[271]

Finding, among other things, that the taxpayer's "customers are generally oil and gas exploration and production companies" who "purchase, license, and use [the taxpayer's] seismic and sound recordings and images to determine where to explore and drill for oil and gas" and that the services and products furnished by the taxpayer "are an integral, essential, and direct component of the oil and gas drilling process," the district court concluded that the comptroller improperly denied the taxpayer's COGS deduction because the taxpayer

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264 *Newpark Res., Inc.*, 422 S.W.3d at 50–51. The Comptroller apparently found it reasonable to force a group of entities to pick one kind of deduction for the whole group based on the group's business activities—even when some members of the group would not independently qualify for that deduction under the tax code—and then deny the group any kind of deduction for the non-qualifying members' expenses.

265 *Id.* at 51–53.

266 TAX § 171.1012(i).

267 Hegar v. CGG Veritas Services (U.S.), Inc., No. 03-14-00713-CV, 2016 WL 1039054, at *2, *4 (Tex. App.—Austin Mar. 9, 2016, no pet.).

268 *Id.* at *1–2.

269 *Id.*

270 *Id.* at *2. The taxpayer's alternate argument was that that the audio and visual recordings it sells qualify as "goods" under Section 171.1012(a)(3)(A). *See id.* The trial court did not rule on this issue. *See id.*

271 *Id.*

"furnished labor and materials to projects for the construction, improvement, remodeling or repair of oil and gas wells" (i.e., real property).[272]

On appeal, the comptroller argued that "even if [the taxpayer's] activities qualify as 'labor and materials' within the meaning of subsection 171.1012(i), they are too far removed from the construction of an oil and gas well to qualify for [the COGS] deduction."[273] However, the Third Court of Appeals held that there was sufficient evidence on the record to uphold the district court's conclusion that "the seismic data acquisition and processing [the taxpayer] performs for its oil and gas exploration and production company customers is 'labor furnished to a project for the construction of real property,'" and affirmed in favor of the taxpayer.[274] The comptroller was initially expected to file a petition for review in the Texas Supreme Court, but decided against doing so.[275]

b. Labor Costs Attributable to Installation of Goods

Generally, an entity can include in its COGS deduction "all direct costs of acquiring or producing the goods," which includes (among other things) "labor costs," "cost of materials that are an integral part of specific property produced," and "cost of materials that are consumed in the ordinary course of performing production activities."[276] The Texas Tax Code defines "production" to include "construction, installation, manufacture, development, mining, extraction, improvement, creation, raising, or growth."[277] A recent case successfully challenged the Texas comptroller's interpretation of the statutory definition of "production."[278]

In *Autohaus, LP, LLP v. Combs,* the taxpayer was an automotive dealership based in Plano, Texas.[279] On its 2009 Texas franchise tax report, the taxpayer claimed a COGS deduction that included costs that the taxpayer incurred in repairing vehicles ("repair costs").[280] These repair costs consisted of both the cost of materials and the cost of labor for installing automotive parts.[281] Among other things, the comptroller disallowed the taxpayer's deduction for the labor portion of the repair costs attributable to repairs performed on customer-owned vehicles.[282]

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272 *See id.* at *1, *4.

273 *Id*. at *4.

274 *Id*. at *4–5.

275 On May 31, 2016, the comptroller informed the Texas Supreme Court that it did not intend to file a petition for review in this case. *See* Letter from Ken Paxton, Attorney General of Texas, to Blake A. Hawthorne, Clerk of the Supreme Court of Texas, http://www.search.txcourts.gov/SearchMedia.aspx?MediaVersionID=571b44bc-2079-493b-a656-970415e2d389&coa=cossup&DT=OTHER&MediaID=3d849f78-fcc8-4170-a42f-5dec4a9384a1 (last visited Nov. 7, 2016).

276 TEX. TAX CODE ANN. § 171.1012(c) (West 2015).

277 *Id*. at (a)(2).

278 *See* Autohaus, L.P. v. Combs, No. D-1-GN-13-000989 (419th Dist. Ct. Travis County, Tex. Mar. 22, 2013). This case is currently pending in the Third Court of Appeals. *See* Hegar v. Autohaus, L.P., No. 03-15-00427-CV (Tex. App.—Austin).

279 Plaintiff's Original Petition at 2, Autohaus, L.P. v. Combs (No. D-1-GN-13-000989.).

280 *See* Plaintiff's Motion for Summary Judgment and Incorporated Brief at 1–2, Autohaus, L.P. v. Combs (No. D-1-GN-13-000989).

281 *See id*. at 2.

282 Plaintiff's Original Petition, *supra* note 279, at 3; Defendants' Response to Plaintiff's Motion for Summary

In district court, the comptroller asserted that the taxpayer could not include labor costs for repair work to customer-owned automobiles in its COGS deduction based on Section 171.1012 of the Texas Tax Code and Comptroller Rule 3.588.[283] To support its assertion, the comptroller argued (among other things) that Section 171.1012 of the Texas Tax Code is ambiguous with respect to "mixed transactions" (i.e., those involving "both the sale of a good and the provision of a service") such as a transaction that involves both selling a replacement automobile part to a customer and installing the part in the customer's automobile.[284] Building on its position that Section 171.1012 of the Texas Tax Code is ambiguous with respect to "mixed transactions," the comptroller maintained that "Subsections (b)(7) and (c)(7) of Rule 3.588 clarify that where there is a mixed transaction involving the service that includes the installation of a product owned by a business into property already owned by a customer, the installation labor retains its character as a service to the customer and so is not deductible as a cost of goods sold."[285]

The taxpayer countered that the language of Section 171.1012(a)(2) setting forth the definition of the term "production" is clear and unambiguous.[286] The statute provides that the term "production" includes "construction, installation, manufacture, development, mining, extraction, improvement, creation, raising, or growth."[287] The Comptroller Rule interpreting Section 171.1012(a)(2) defines "production" as "[c]onstruction, manufacture, *installation occurring during the manufacturing or construction process*, development, mining, extraction, improvement, creation, raising, or growth."[288] The taxpayer pointed out that, in contrast to the statutory definition of "production," the Comptroller Rule's definition of "production" limits the "installation" component of production to "installation *occurring during the manufacturing or construction process*."[289] The taxpayer contended that, because the "Texas Tax Code's definition of 'production' is clear and unambiguous . . . and since Texas Comptroller Rule 3.588(b)(7) . . . attempts to alter an unambiguous statue" by defining "production" differently from the statute, the Rule "is invalid and not entitled to deference."[290]

The district court rendered judgment in favor of the taxpayer, ruling that "Texas Comptroller Rule 3.588(b)(7) as it applies to the term 'production' is unconstitutional and invalid" and that the taxpayer "is entitled to include all of its labor costs associated with Repair

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Judgment, Defendants' Cross-Motion for Summary Judgment, and Defendants' Plea to the Jurisdiction at 88, Autohaus, L.P. v. Combs (No. D-1-GN-13-000989) (filed June 17, 2014).

283 Defendants' Response to Plaintiff's Motion for Summary Judgment, Defendants' Cross-Motion for Summary Judgment, and Defendants' Plea to the Jurisdiction, *supra* note 282, at 12–22.

284 *Id*. at 13–15.

285 *Id*. at 15. Subsection (b)(7) of Rule 3.588 provides as follows: "Production—Construction, manufacture, installation occurring during the manufacturing or construction process, development, mining, extraction, improvement, creation, raising, or growth." TEX. ADMIN. CODE ANN. tit. 34, § 3.588(b)(7) (West 2015). Subsection (c)(7) provides as follows: "Mixed transactions. If a transaction contains elements of both a sale of tangible personal property and a service, a taxable entity may only subtract as cost of goods sold the costs otherwise allowed by this section in relation to the tangible personal property sold." *Id*. § 3.588(c)(7).

286 *See* Plaintiff's Motion for Summary Judgment and Incorporated Brief, *supra* note 280, at 6.

287 TEX. TAX CODE ANN. § 171.1012(a)(2) (West 2015).

288 tit. 34, § 3.588(b)(7) (emphasis added).

289 *Id.*; *See* Plaintiff's Motion for Summary Judgment and Incorporated Brief, *supra* note 280, at 8.

290 Plaintiff's Motion for Summary Judgment and Incorporated Brief, *supra* note 280, at 8. The taxpayer also asserted that the comptroller's denial of the COGS deduction and subsequent assessment of tax violated several provisions of the Texas and United States Constitutions. *See id*. at 14–17.

Costs . . . involved in the installation of automotive parts in its costs of goods sold deduction."[291] Having been appealed by the comptroller, *Autohaus* is pending in the Third Court of Appeals at the time this article is being written. Given the subject matter of *Autohaus*, the scope of its outcome could reach well beyond the *Autohaus* taxpayer and the specific Comptroller Rule that is at issue in this case.

VI. FINAL ACT & CURTAIN CALL?

As discussed previously, the margin tax has met with poor reviews from taxpayers and experts. It has performed dismally and failed at its intended role as the solution to the school funding problem that Texas faced in 2005. Attacks on the tax have consumed untold government resources as staff at the offices of the comptroller and attorney general defend countless challenges with no end in sight.[292] Adding insult to injury, the margin tax has been faulted for putting a damper on the Texas economy.[293]

A. Effect on Texas Economy

A recent report by the National Center for Policy Analysis concluded that the margin tax "directly discourages business and investment by taxing the difference between a business's revenue and certain costs."[294] Researchers at the National Federation of Independent Business Research Foundation and the Tax Foundation have reached similar conclusions.[295] The results of studies performed by the Beacon Hill Institute and Texas Public Policy Foundation correspond with the findings of other researchers.

In 2012, researchers at the Beacon Hill Institute for Public Policy Research at Suffolk University conducted a study to project the impact on the Texas economy of abolishing the margin tax.[296] According to the institute's report, the margin tax "exerts a negative effect on investment, job creation and output that would otherwise take place in its absence."[297] Using a computable general equilibrium modeling program to calculate the "dynamic revenue effects" that would result five years following the elimination of the margin tax, the institute found that eliminating the margin tax would lead to a "significant improvement in the state economy."[298]

The institute's report projected that the change would create tens of thousands of new

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291 Order Granting Plaintiff's Motion for Summary Judgment at 1, Autohaus, L.P. v. Combs (No. D-1-GN-13-000989) (issued July 22, 2014); Final Judgment at 1, 3, Autohaus, L.P. v. Combs (No. D-1-GN-13-000989) (issued April 29, 2015).

292 *See* Haney & Wright, *supra* note 14, at 6 (noting that the margin tax "still faces numerous pending legal challenges, touching on everything from how the state calculates the portion of a company's activity that occurs in Texas to which expenses can be deducted from a firm's total revenue" and predicting that the margin tax "will continue to be subject to legislative changes and court challenges for the foreseeable future.").

293 *See* Drenkard, *supra* note 43 (observing that "Texas' tax code has a lot of desirable elements. . . . What holds the state back, though, is its franchise tax, most commonly called the Margin Tax").

294 *See* Murphy, *supra* note 55, at 3.

295 *See* Chow, *supra* note 52; Drenkard, *supra* note 43.

296 *See Tax Reform in Texas, supra* note 95. The study, which was published in 2012, is based on a model that simulated the economic effects of eliminating the margin tax beginning in the year 2013. *Id*.

297 *Id*. at 4.

298 *Id*. at 6.

jobs, increase Texans' real disposable income, and add billions in investments to the state's economy.[299] This projected positive effect on the Texas economy following repeal of the margin tax would come as a result of "businesses [having] more money to make profitable investments in Texas, thus increasing investment and employment, incomes and retail sales which, in turn, push sales, property and other tax collections higher."[300]

Last year, the Texas Public Policy Foundation developed an econometric model to study the effects of eliminating the margin tax.[301] Their analysis indicates that "margin tax substantially depresses real personal income and private sector nonfarm job growth" and "eliminating the margin tax would free resources that would substantially boost the economy after the first year," which would result in the creation of tens of thousands of new jobs and significantly increase Texans' incomes.[302]

B. #ENDTHEMARGINTAX[303]

It appears that the margin tax may be in its final act.[304] Given the poor financial performance of the margin tax and researchers' findings that the tax is hampering the Texas economy, it comes as no surprise that there have been numerous calls for the repeal of the margin tax. One commentator has stated that "it would be in the state's best interest to eliminate the tax entirely in order to reduce the complexity and costliness of the state's tax code."[305] In a report issued by the 2011–12 Texas Conservative Coalition Research Institute's State Taxation and Revenue Task Force (chaired by State Senator Dan Patrick, State Senator Ken Paxton, and State Representative Jim Murphy), lawmakers were urged to "break with the past and advocate for repeal of the Texas franchise tax."[306] The results of a 2013 economic simulation performed by the National Federation of Independent Business Research Foundation showed that phasing out the margin tax would benefit the Texas economy because it would "allow taxable business entities to retain more of their pre-tax income to finance business expansion, build cash reserves, enhance worker compensation, and provide better returns to shareholders."[307] One economist recently predicted that ending the margin tax would give Texas "one of the most competitive tax climates in the country."[308] Earlier this year, lawmakers were encouraged by the Texas Conservative Coalition Research Institute to "stay the course" on a path toward eliminating the margin tax.[309]

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[299] *Id*.

[300] *Id*. at 5.

[301] Ginn & Heflin, *supra* note 45, at 10.

[302] *Id*. at 12.

[303] TWITTER, https://twitter.com/hashtag/ENDthemargintax?src=hash (last visited Nov. 7, 2016).

[304] *See supra* notes 9–11 and accompanying text.

[305] Morgan Scarboro, *Texas Legislature Passes $2.56 Billion Tax Cut Package*, TAX FOUND. (Jun. 1, 2015), http://taxfoundation.org/blog/texas-legislature-passes-256-billion-tax-cut-package (noting that eliminating the margin tax would "increase Texas' Business Tax Climate ranking from 10th in the country to an impressive 3rd").

[306] *See Final Report of the TCCRI*, *supra* note 43, at 10.

[307] Chow, *supra* note 52.

[308] Drenkard, *supra* note 6, at 11.

[309] *Written Testimony to the Senate Committee on Finance*, TEX. CONSERVATIVE COAL. RES. INST. (Mar. 30, 2016), http://txccri.org/wp-content/uploads/2016/04/Senate-Finance-Testimony-Franchise-Tax-3.30.16.pdf.

Is it time for the curtain to close on the margin tax? Some Texas lawmakers appear to think so. "Nearly 100 bills and resolutions relating to the franchise tax were filed in the 2015 legislative session, 13 of which would repeal it entirely."[310] While the 2015 legislative session did not result in the elimination of the margin tax, it did result in the passage of a bill that significantly reduces the tax burden on taxpayers starting with the 2016 tax year. [311] In the same bill, the legislature clearly signaled intent to repeal the margin tax.[312]

VII. CONCLUSION

The Texas margin tax was introduced to taxpayers in 2008 with the hope that it would resolve the state's serious school finance problems. Instead of welcoming the margin tax as a practical solution for funding Texas' public schools, taxpayers, experts, and other parties impacted by the tax have been outspoken in their disdain for the new tax structure. The critics have been harsh and the tax has garnered opponents from across the country. In addition to the margin tax being the target of widespread dislike, it has underperformed financially and is considered to be responsible for hindering the growth of the Texas economy.

The future of the margin tax is uncertain in light of the numerous legal attacks against it, its disappointing financial performance, and its impact on the Texas economy. Although there have been numerous attempts to fix many of the problems that exist in the structure of the tax, it might be best to scrap it altogether rather than continue futile piecemeal repairs. With little reason to celebrate the approaching tenth anniversary of the debut of the margin tax, its repeal may be the best gift for taxpayers and the comptroller alike. Many would likely agree that it is "time to end this complex, inefficient tax that places a substantial burden on businesses, individuals, and families across the income spectrum and unleash Texas' entrepreneurial spirit so that all Texans, including the working poor, will enjoy the benefits of more jobs and greater economic prosperity."[313] Indeed, it appears the final curtain may be descending on the saga of the Texas margin tax. Perhaps it is time for the Texas margin tax to take a final bow and exit stage left.

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310 Haney & Wright, *supra* note 14, at 6.

311 *See* Act of June 15, 2015, 84th Leg., R.S., ch. 449, §1(b) (cutting the tax rate for retailers and wholesalers to.375 percent and to .75 percent for all other business, as well as reducing the EZ Computation rate to .331 percent).

312 *See id*.

313 Ginn & Heflin, *supra* note 45, at 4.

Representing Taxpayers in Sensitive Audits

A Look at the Fundamental Challenges of an Eggshell Audit

By Jason B. Freeman, JD, CPA | Column Editor

Sensitive audits present the tax practitioner with unique challenges. They require the exercise of judgment and discretion, as well as an understanding of administrative procedure and even a command of constitutional and evidentiary rules. At times, they may also require that the practitioner carefully balance duties to a client with their own ethical and legal obligations.

Sensitive audits come in several forms. An "eggshell" audit, for instance, is a civil audit that has the potential to turn criminal. There are lurking issues – potential tax fraud or evidence of other legal violations, such as money laundering or structuring – that the auditor may discover. A "reverse eggshell audit" involves a civil tax audit that is being conducted alongside a parallel criminal investigation. Sensitive audits may also involve undisclosed parallel investigations by other state or federal agencies.

Such audits often raise a host of issues. For instance, should the taxpayer file an amended return to correct prior mistakes? What about the obligation to file a current year return while the audit is ongoing? When does the taxpayer have a valid privilege against providing certain information or documents, and what steps or events might inadvertently waive that privilege? What are the signs that a taxpayer may have been referred criminally? Eggshell audits often bring these questions and others to the forefront.

Amended Returns, Current Returns and Admissions

The question of whether to file an amended return is one that frequently surfaces in the context of sensitive audits. The decision is one that should be analyzed carefully. An amended return filed after an audit or investigation has begun will not remove tax fraud that exists with respect to an original return, although in certain circumstances an amended return may be a factor that potentially militates against a criminal prosecution or helps show a lack of willfulness. An amended tax return, or any tax return for that matter, is a sworn statement filed by a taxpayer under penalty of perjury. It can therefore be used as an evidentiary admission against the taxpayer, perhaps even relieving the government of the burden to produce other (more difficult to obtain) evidence that may be necessary to successfully bring a criminal case.

What about returns that come due during an audit? A pending audit or even a criminal investigation does not excuse a failure to file a current return, even where that return would require disclosures that make it clear that a prior return that is under audit was not filed correctly. It is a crime to willfully fail to file a tax return and tax representatives have an ethical obligation under Circular 230 to advise a client of this requirement and the potential penalties for failing to do so. As a practical matter, it will often be advisable to obtain an extension of the deadline in order to buy time and to learn more about the focus of the audit.

In some circumstances, a taxpayer may need to file a so-called Fifth Amendment return, a tactic that must be approached carefully. In doing so, taxpayers cannot, for example, make a blanket Fifth Amendment claim over their entire return, but instead must assert the privilege on an item-by-item basis. A failure to properly file such a return may compound existing problems, potentially subjecting the taxpayer to "frivolous return" penalties or even criminal prosecution for willfully failing to file a return.

Parallel Proceedings and *Tweel* Violations

Sensitive audits inevitably involve the potential for parallel proceedings, which raise unique concerns. Courts have developed guidelines to police the IRS in this context, particularly when it conducts parallel civil and criminal tax investigations. Perhaps the seminal case in this arena is *United States v. Tweel*. Under that case and its progeny, simultaneous civil and criminal audits are not prohibited. Nor does the government have any outright duty to inform a taxpayer that matters arising in a civil audit could be used in a criminal investigation.

At the same time, however, the IRS may not use its civil arm to conduct or further a criminal investigation and employ "deceit, trickery or misrepresentation." That means, for instance, that an auditor cannot lie when asked if he/she has made a criminal referral or whether a parallel criminal investigation is ongoing. Violations of this rule – so-called *Tweel* violations – can lead to the suppression of evidence on Fourth Amendment grounds.

The Privilege

One of the first steps in properly handling a sensitive audit is to assess and ensure the preservation of the privilege. Does the client, for example, have information or possession of documents that could expose the client to criminal sanctions? If so, that information needs to be assessed and steps should be taken to avoid a waiver of the privilege. Taxpayers faced with an audit interview may need to consider invoking the privilege with respect to questions that would elicit incriminating responses. Where the IRS seeks documents that contain incriminating information (or where their very existence may prove incriminating), the act-of-production privilege may protect a taxpayer from being compelled to produce the documents.

At the same time, the applicability of countervailing doctrines, such as the required records doctrine or the "collective entity" doctrine, should also be analyzed. Practitioners and their clients should carefully vet the risks and benefits of asserting a privilege, as well as the proper manner for doing so.

In the process of vetting sensitive issues, such as the very existence of a privilege, practitioners should be careful to ensure that those

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discussions themselves are privileged, lest the practitioner inadvertently convert himself/herself into a key witness against the client that can be compelled to disclose the content of those discussions. Many an accountant has been compelled to provide documents and testimony against their client because communications that they believed to be privileged were, in fact, not. For example, *United States v. Spencer*, 700 F.3d 317 (8th Cir. 2012) presents a case where the accountant-CPA was required to testify against his client at the client's criminal trial. As a matter of risk management, practitioners handling sensitive audits should have a firm grasp of the limits of the accountant-client privilege.

There are many misconceptions about the scope of the federal accountant-client privilege under Section 7525 of the Internal Revenue Code. In fact, many are not aware that the accountant-client privilege is not available where it is needed most: It does not apply in criminal proceedings. Nor, for that matter, does it apply in other proceedings outside the federal tax context – for example, divorce, SEC or even state tax proceedings. In fact, courts have held that it does not even apply to communications engaged in for the purpose of preparing a tax return, raising the question of what exactly it does protect. Against this background, care must be taken to protect communications about sensitive matters.

Despite the extremely limited scope of the federal accountant-client privilege, an accountant can often be cloaked with an actual common law attorney-client privilege through the use of a *Kovel* arrangement. Under *United States v. Kovel*, the federal case that lends its name to the arrangement, an attorney may engage an accountant to assist with the audit and thereby extend the more robust attorney-client privilege to the accountant. Where properly employed, this tool brings an accountant under the umbrella of the attorney-client privilege and protects accountant communications, helping to ensure that the accountant cannot later be compelled to testify against the client.

Beware of Potential Pitfalls

Sensitive audits often create potential pitfalls for the representative themselves. The practitioner must always take steps to ensure that they abide by both governing ethical rules and statutes. For instance, a practitioner cannot make a false representation to an IRS agent, but at the same time may be prohibited from disclosing privileged information without the client's consent. Practitioners who violate these rules (and others) risk disbarment from practice before the IRS or, worse yet, committing a federal crime themselves.

Among the more commonly encountered criminal statutes that have been turned against practitioners in this context, Section 7206(2) of the Internal Revenue Code makes it a crime to aid or assist in the presentation of a false or fraudulent document. Similarly, Section 7212, a broadly worded statute, makes it a crime to attempt to obstruct or impede the administration of the Internal Revenue laws. The government will use these provisions and others to bring criminal charges against practitioners where it believes a violation exists. Practitioners must therefore take all necessary steps to ensure that they abide by any governing rules throughout the proceedings. This requires a more concerted and proactive effort than may generally be necessary outside of the sensitive-audit context.

The Fraud Development Process Generally

When a field auditor uncovers indicators of fraud, IRS procedures require the auditor to meet with his/her group manager and, where the manager concurs, to initiate contact with a Fraud Technical Advisor (FTA). The FTA plays a central role in the development of potential fraud cases and is involved in all cases with potential criminal fraud or civil fraud penalties. If the auditor, group manager and FTA agree that there is a potential for fraud, the auditor prepares Form 11661, *Fraud Development Recommendation – Examination*, the case is placed in fraud development status and a fraud development plan is formulated.

If an auditor subsequently identifies affirmative acts of fraud, the auditor is required to suspend examination activity without disclosing the reason for the suspension. Radio silence (or an auditor's abrupt cancellation of a scheduled meeting or extended failure to respond) can thus imply a potential criminal referral.

If criminal criteria are met, the FTA will ultimately recommend a referral to the IRS Criminal Investigation Division (CI) and the auditor will refer the case through the FTA to CI via Form 2797, *Referral Report of Potential Criminal Fraud Cases*. Shortly thereafter, the CI special agent assigned to the case will initiate a conference with the auditor, his/her group manager, the supervisory special agent, and the FTA to review the evidence gathered to support the charges.

The conference will cover a number of issues that bear on CI's decision whether to accept the referral, including the amount of the additional tax due, the flagrancy of the alleged violation, any public interest in the matter and the deterrent effect that would be achieved from proceeding. Generally, within 30 days of this conference, the same group will confer again to discuss CI's decision to accept or decline the referral.

'Badges' of Fraud

In developing fraud cases, auditors look for indicators of fraud – known as "badges" of fraud – to establish fraudulent behavior. Most fraud cases involve individuals and business taxpayers with poor or nonexistent internal controls or a lack of separation of duties, but tax fraud can occur in many contexts. While by no means an exhaustive list, some of the common "badges" or indicators of fraud that the IRS looks for include the following: Omitting specific items where similar items are included; omitting entire sources of income; an inability to explain substantial increases in net worth; inadequately explaining dealings in large sums of currency; dealings in cash; failing to file a tax return, especially for a period of several years, despite evidence of substantial amounts of taxable income; claiming fictitious or substantially overstated deductions; claiming substantial business expense deductions for personal expenditures; providing false or altered documents; keeping multiple sets of books; failing to keep adequate records; the existence of false book entries or alterations, back-dated documents or false invoices; variances between the tax return and books; inclusion of income or deductions in the tax return of a related taxpayer when tax rate differences are a factor; the use of secret bank accounts; conducting business transactions in false names; making false statements; attempting to obstruct the examination; failing to make full disclosure; holding assets in the name of others; and a pattern of consistent failures to report income over multiple years. Again, this is only a partial list of the potential indicators of fraud that the IRS looks to, but where any such indicators exist, a taxpayer's risk of criminal referral may increase.

Signs of a Criminal Referral

At all times during the audit, a practitioner should remain alert to signs that the civil audit may have "gone" criminal. The signs will vary depending on the context and the nature of the case. However, there are several indicators that have traditionally been signs that a potential referral may have taken place or may be imminent. For instance, where a revenue officer copies extensive documents or requests original documents rather than copies, these may be signs that the auditor is building the basis for a referral. If the agent focuses on "intent"-based questions, such as what the taxpayer knew or why certain items were deducted, this may also be a sign.

Other signs include excessive interest or focus on sensitive transactions, efforts to obtain information from third parties that could have easily been obtained from taxpayer records, seeking to meet with the taxpayer more than once, requesting sworn affidavits from the taxpayer or third parties, conducting a large number of third-party interviews, and questions about the taxpayer's lifestyle and financial status. Of course, a visit from a CI special agent is the ultimate sign that a civil audit has turned criminal.

Navigating the Process

Sensitive audits require a unique skillset and knowledge base. To navigate the process and maximize a client's prospect for success, the practitioner must be able to identify trouble spots ahead of time and assess any applicable procedural rights, as well as formulate an adaptive strategy.

Throughout the process, the practitioner must be attuned to a host of subtle signs and clues, and be able to identify the opportunities to help steer the audit in the right direction. And, of course, along with a firm grasp of the background principles and administrative processes, the practitioner must fully understand, and always remain mindful of, their own ethical and legal obligations. ■

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Estate and Gift Tax Implications with an Agent's Power to Make Gifts under the New Texas Durable Power of Attorney Statute

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Although it was not one of the headline grabbing bills, the new Texas Power of Attorney Act (the "Act") that was passed in the 85th legislative session is certainly worthy of attention. After numerous proposals to modernize Texas' statutes were advanced by the Real Estate, Probate and Trust Law section of the State Bar of Texas and countless hours were spent negotiating compromises with various stakeholders (most notably financial institutions and the Texas Business Law Foundation), the new Act was finally passed in the waning hours of the session.

This article focuses on the estate and gift tax issues for an agent that may arise under new provisions added to the Act that allow a principal to give an agent the power to make gifts, referred to sometimes as "hot powers." While many practitioners may already have been including gifting powers as part of a customized durable power of attorney, these provisions were not previously part of the statutory form or specifically provided by statute. The inclusion of these provisions in the Act clarifies that an agent can hold these types of powers for the principal. Note, however, that these new powers are not part of the statutory form under the Act. They are included as a separate section that can be incorporated into the durable power of attorney. Hopefully, this separation will facilitate thoughtful analysis of the tax implications that must be taken into account before these powers are added to a durable power of attorney.

Texas Estates Code ("TEC") § 751.031[1] specifically provides that a principal can allow an agent, if expressly authorized by the principal and not otherwise prohibited by another agreement or instrument, to enter into certain estate planning transactions on behalf of the principal, including to: create, amend, revoke or terminate inter vivos trusts; make gifts with certain limitations; and create or change rights of survivorship and beneficiary designations. Agents who are not an ancestor, spouse or descendant of the principal may not exercise such powers to their own benefit unless specifically permitted in the power.

In addition, TEC § 751.032[2] provides that a principal can allow an agent to make gifts to a trust, a Uniform Transfers to Minors Account, or a tuition savings plan. Due to the interrelation of TEC §§ 751.031 and 751.032, unless the gifting powers are customized, any gifting authority granted to an agent in the durable power of attorney that includes the statutory gifting provisions will be limited to the annual exclusion amount (or double that amount if the principal's spouse consents to gift split under Internal Revenue Code ("IRC") § 2513).[3] Any gifts made must be consistent with the principal's objectives, if known, or if not known, as consistent with principal's best interest, based on all relevant factors (including the principal's property and foreseeable obligations, tax minimization goals, assistance program eligibility desires, and history of gift-making).

Regardless of the scope of the gifting authority granted to the agent, the tax implications should always be considered. While the principal will obviously make a gift if the agent exercises the authority, the mere possession of the gifting authority could also have tax implications for the agent if exercisable for his or her own benefit (or for his or her creditors, estate or creditors of his or her estate). In that event, the concern is that the agent may be deemed to hold a general power of appointment under IRC § 2041. If a general power is held at the agent's death, the property over which the agent has a general power will be includible in his or her estate for estate tax purposes. Likewise, an agent could be deemed to have released the purported general power of appointment under IRC § 2514 if he or she permits the gifting discretion to lapse in part or entirely. Arguments can be made in support and in defense of both conclusions.

On the one hand, an agent with the ability to make gifts to himself or herself arguably should not be deemed to have a general power of appointment under IRC § 2041(b)(1)(C)(i), which provides that a power that is exercisable only in conjunction with the power's creator is not a general power of appointment. Clearly, the principal can revoke the agent's authority at any time, as can a court via the appointment of a guardian for the principal. In effect, the agent can only exercise the gifting discretion as long the principal continues to provide the agent with that discretion, which pursuant to IRC § 2041(b)(1)(C)(i) arguably means the agent and principal must exercise the discretion together. As such, the agent should not be deemed to hold a general power of appointment.

Alternatively, one could argue that by granting the gifting authority to the agent, the principal has prospectively consented to any exercise of that discretion by the agent prior to its revocation. Under this reasoning, the agent can exercise the gifting discretion unilaterally without the need to seek the principal's consent, which arguably could negate the applicability of the IRC § 2041(b)(1)(C)(i) exception. If so, even if the principal ultimately revokes the agent's authority, the revocation would inherently take place after the agent was arguably deemed to have a general power of appointment.

Although the authors have not located a case or ruling in which the Internal Revenue Service has taken the position that an agent under a durable power of attorney held a general power of appointment in such capacity, we believe that it may be prudent to consider limiting the powers granted to address this concern. Below are a few suggestions to consider in this regard.

If the agent's authority to make gifts to himself or herself is limited to the gift tax annual exclusion amount, then there would be in any year only an equivalent amount of estate inclusion exposure under IRC § 2041 if the agent were to die prior to exercising the discretion. Obviously, if the agent exercises the discretion in any year to make an outright gift to himself or herself, then the gifted amount would be includible in his or her estate if still held at death. There would likely be no taxable gift exposure under IRC § 2514 if the agent failed to exercise that limited gifting discretion in any year (whether due to the agent's conscious decision to forgo exercising the discretion or due to a failure to exercise it before the death of either the principal or the agent) if the annual exclusion amount represents less than 5% of the principal's wealth out of which the exercise of the lapsed power could have been satisfied. This is due to IRC § 2514(e), which provides an exception for property that could have been appointed via the lapsed power to the extent it does not exceed the greater of $5,000 or 5% of the aggregate value of the property out of which the exercise of the lapsed power could have been satisfied (commonly referred to as the “5 and 5” amount).

In addition, the possible estate inclusion risk could be mitigated by providing the agent with the gifting discretion only during a limited period of time each year (e.g., during a specified month) or by limiting any gift amount to an ascertainable standard (e.g., health, education, maintenance, and support). Any gifting powers limited to an ascertainable standard should also prohibit the agent from making a gift that would discharge the agent’s legal obligation of support to another to avoid treatment as a general power of appointment. See Treas. Reg. § 20.2036-1(b)(2).[4]

Alternatively, the agent could be permitted to make gifts only if the gifting power is exercised in conjunction with another person who has a substantial interest in the property, subject to the power of appointment, which is adverse to the exercise of the power. IRC § 2041(b)(1)(C)(ii). Utilizing this exception may be complicated as a practical matter. The principal could change his or her estate plan in a way that would affect who would have an interest in the appointable property sufficiently substantial to fulfill this role. Multiple successor individuals may need to be included in this role to take into account the possibility of the death of the designated person whose interest would be adverse. In addition, determining the proper person to fulfill this role will be highly fact-intensive and would require an analysis of whose interest is “substantial” and the effect of multiple initial and successor beneficiaries. Use of this exception will require a high degree of maintenance and review, which will likely eliminate it from being used in most cases. A close review of the regulations under IRC § 2041 is recommended before attempting the use of this exception.

If the principal prefers not to limit the agent’s gifting authority so that the agent can pursue more aggressive estate planning on the principal’s behalf, then it may be prudent to consider granting the gifting authority to an individual who is not related to the principal and is therefore not someone to whom the principal wishes gifts to be made. All other authority under the power of attorney could be reserved to the principal’s primary agent.[5] This arrangement is similar to a “trust protector” or “special trustee” role often used in trust agreements. The durable power of attorney could prohibit the agent from making gifts to himself or herself in any amount, while leaving the gifting powers otherwise unlimited.

Similar gift and estate tax concerns apply if a principal authorizes an agent to change beneficiary designations and enter into or change pay on death, rights of survivorship or trust accounts in favor of the agent. TEC § 751.033. It may be wise to consider adding any limitations imposed on an agent’s gifting powers to these powers as well.

Many practitioners will welcome the new statutory “hot powers” and the additional flexibility they provide to an agent to advance the principal’s objectives. However, as with the addition of any new provision to a form, practitioners should always carefully consider the scope of the discretion provided to each agent when adapting the form for a client so that the discretion will be tailored as appropriate to further that client’s unique planning goals and other objectives.

[1] Sec. 751.031. GRANTS OF AUTHORITY IN GENERAL AND CERTAIN LIMITATIONS. (a) Subject to Subsections (b), (c), and (d) and Section 751.032, if a durable power of attorney grants to an agent the authority to perform all acts that the principal could perform, the agent has the general authority conferred by Subchapter C, Chapter 752.

(b) An agent may take the following actions on the principal's behalf or with respect to the principal's property only if the durable power of attorney designating the agent expressly grants the agent the authority and the exercise of the authority is not otherwise prohibited by another agreement or instrument to which the authority or property is subject:

(1) create, amend, revoke, or terminate an inter vivos trust;

(2) make a gift;

(3) create or change rights of survivorship;

(4) create or change a beneficiary designation; or

(5) delegate authority granted under the power of attorney.

(c) Notwithstanding a grant of authority to perform an act described by Subsection (b), unless the durable power of attorney otherwise provides, an agent who is not an ancestor, spouse, or descendant of the principal may not exercise authority under the power of attorney to create in the agent, or in an individual to whom the agent owes a legal obligation of support, an interest in the principal's property, whether by gift, right of survivorship, beneficiary designation, disclaimer, or otherwise.

(d) Subject to Subsections (b) and (c) and Section 751.032, if the subjects over which authority is granted in a durable power of attorney are similar or overlap, the broadest authority controls.

(e) Authority granted in a durable power of attorney is exercisable with respect to property that the principal has when the power of attorney is executed or acquires later, regardless of whether:

(1) the property is located in this state; and

(2) the authority is exercised in this state or the power of attorney is executed in this state.

[2] Sec. 751.032. GIFT AUTHORITY. (a) In this section, a gift for the benefit of a person includes a gift to:

(1) a trust;

(2) an account under the Texas Uniform Transfers to Minors Act (Chapter 141, Property Code) or a similar law of another state; and

(3) a qualified tuition program of any state that meets the requirements of Section 529, Internal Revenue Code of 1986.

(b) Unless the durable power of attorney otherwise provides, a grant of authority to make a gift is subject to the limitations prescribed by this section.

(c) Language in a durable power of attorney granting general authority with respect to gifts authorizes the agent to only:

(1) make outright to, or for the benefit of, a person a gift of any of the principal's property, including by the exercise of a presently exercisable general power of appointment held by the principal, in an amount per donee not to exceed:

(A) the annual dollar limits of the federal gift tax exclusion under Section 2503(b), Internal Revenue Code of 1986, regardless of whether the federal gift tax exclusion applies to the gift; or

(B) if the principal's spouse agrees to consent to a split gift as provided by Section 2513, Internal Revenue Code of 1986, twice the annual federal gift tax exclusion limit; and

(2) consent, as provided by Section 2513, Internal Revenue Code of 1986, to the splitting of a gift made by the principal's spouse in an amount per donee not to exceed the aggregate annual federal gift tax exclusions for both spouses.

(d) An agent may make a gift of the principal's property only as the agent determines is consistent with the principal's objectives if the agent actually knows those objectives. If the agent does not know the principal's objectives, the agent may make a gift of the principal's property only as the agent determines is consistent with the principal's best interest based on all relevant factors, including the factors listed in Section 751.122 and the principal's personal history of making or joining in making gifts.

[3] All references herein to the "IRC" are to the Internal Revenue Code of 1986, as amended.

[4] All references herein to "Treas. Reg." are to the regulations promulgated under the IRC.

[5] Providing for each of the principal's children to be permitted to make gifts to each other (but not himself or herself) may not avoid taxation pursuant to IRC §§ 2041 and 2514 due to reciprocal gifting concerns. See U.S. v. Grace, 395 U.S. 316 (1969); Sather v. Comm'r, T.C.M. 1999-309 (1999), *aff'd*, 251 F.2d 1168 (8th Cir. 2001); Schuler v. Comm'r, T.C.M. 2000-392 (2000), *aff'd*, 282 F.2d 575 (8th Cir. 2002).

Texas Sales Tax Rules for Declared Disaster Areas

By: Jimmy Martens, Danielle Ahlrich & Katie Wolters
Martens, Todd, Leonard & Ahlrich

In August of 2017, Hurricane Harvey devastated much of the Texas coastal region. The storm remained in Texas for days after landfall, creating catastrophic flooding that ravaged major cities where Texans live and work. Preliminary estimates indicate that over 185,000 homes were damaged or destroyed.[1]

In response, Governor Abbott designated a long list of Texas counties as disaster areas: Aransas, Austin, Bastrop, Bee, Brazoria, Calhoun, Chambers, Colorado, DeWitt, Fayette, Fort Bend, Galveston, Goliad, Gonzales, Hardin, Harris, Jackson, Jasper, Jefferson, Karnes, Kleberg, Lavaca, Lee, Liberty, Matagorda, Montgomery, Newton, Nueces, Orange, Polk, Refugio, Sabine, San Jacinto, San Patricio, Tyler, Victoria, Walker, Waller, and Wharton.[2]

Construction services performed in declared disaster areas may or may not be taxable, depending upon the circumstances. This article uses the term "construction" loosely to include all work affecting real property structures, including work to rebuild or repair residential and non-residential structures. The taxability of construction work depends upon the type of customer, the type of work, and the type of contract used by the contractor.

The work to rebuild Texas has just begun, and the project will require a tremendous effort by both Texas and out-of-state contractors. Those who do not have a firm grasp on the Texas sales and use tax rules, including rules specific to disaster relief work, should realize that the uptick in work will likely translate into increased sales tax audits. This article provides contractors and tax professionals with basic answers to construction-related questions specific to declared disaster areas, in the context of a well-known, but fictitious

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[1] Gallagher, J.J., *Hurricane Harvey Wreaks Historic Devastation: By the Numbers*, ABC NEWS (September 1, 2017), available at: http://abcnews.go.com/US/hurricane-harvey-wreaks-historic-devastation-numbers/story?id=49529063.

[2] Office of the Governor of the State of Texas, *Proclamation* (August 23, 2017); *See* Comptroller Rule § 3.357(a)(3) for definition of disaster area; Office of the Governor of the State of Texas, *Proclamation* (September 14, 2017); FEMA, *Texas Hurricane Harvey*, available at: https://www.fema.gov/disaster/4332/.

shrimper. The general rules regarding the taxability of construction services are outside this article's scope, so questions regarding work performed in non-disaster counties should be directed to knowledgeable tax practitioners.

Bubba Gump

Bubba Gump is a shrimper who has lived and worked in Rockport for 20 years. He owns a seafood market in downtown Rockport, less than a mile from his home. Bubba's market is located adjacent to a government-owned dock, where he docks his shrimp boat.

Bubba evacuates during Hurricane Harvey. When he returns to Rockport, he sees widespread destruction. He checks on his market and finds that the storm surge partially-flooded the building, rendering it unusable. Most of the contents and furnishings are destroyed. The government-owned dock also sustained damage, so Bubba calls the county to notify them of the damage.

Bubba then checks on his home. A tree fell on his roof during the storm, creating a hole that allowed water and debris to enter. Bubba begins to sort through the contents to decide what can be salvaged and what must be discarded.

Bubba then seeks bids from contractors to tackle the daunting task of repairing and restoring his home and market. First, Bubba contacts Cleaning & Restoration Services, a contractor who specializes in restoring furniture and contents after a storm. Second, Bubba contacts an arborist to remove the tree from his roof. Third, he contacts a demolition contractor to tear down to studs portions of his house and market. Finally, Bubba hires a contractor to remodel his partially-demolished house and market.

This article discusses the sales tax consequences that ensue from Hurricane Harvey's devastation by applying the disaster-area construction rules to Bubba's circumstances.

Lump-Sum Versus Separated Contracts.

Sales tax consequences vary depending upon the type of pricing in the construction contract. In a separated contract, the agreed contract price is split into separately-stated charges for incorporated materials and for labor. If the charges for incorporated materials and labor are separately-stated, the fact that the charges are added together and a sum total given is irrelevant.

The Comptroller generally classifies both cost-plus-a-fee contracts and time and materials contracts as separated contracts.[3] In certain instances, contracts that incorporate "schedules of value" are classified as separated.

In a lump-sum contract, the agreed contract price is typically stated as a single lump-sum amount. It does not state a separate charge for incorporated materials from the charges for skill/labor. By default, all contracts are lump-sum unless the material charge is separately-stated or identifiable from other charges. Invoices separately stating labor charges from materials charges will not convert a lump-sum contract into a separated contract, unless the terms of the contract require separated invoices.

Generally, a lump-sum contract is viewed as the sale of a service, with the taxability of the labor component driving the taxability of the entire charge. In contrast, a separated contract is viewed as the separate sale of the labor and materials. As a result, the materials are taxable as the sale of tangible personal property, even if the labor is not taxable.

For sales tax purposes, the terms of the contract control change orders.[4] If the contract is classified as lump-sum, then the change orders will be treated as lump-sum, even if the change orders show charges for incorporated materials separate from other charges.[5] If the contract is separated and change orders state lump-sum amounts, then the lump-sum amounts will be treated as charges for incorporated materials unless the contractor can reasonably demonstrate the portion of the charges attributable to labor.[6]

The Resale Exemption.

Since construction charges may include the sale of taxable materials or the performance of a taxable service, a contractor may be entitled to claim a resale exemption when the contractor purchases the materials or services.

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3 *See* Comptroller Hearing No. 10,915 (1980) ("The Comptroller considers cost plus contracts that require complete accounting and invoicing of all costs separated into labor and materials to be separated contracts.").

4 *See* Comptroller Rule § 3.291(b)(5).

5 *See id.*

6 *See id.*

To prevent double taxation, the purchase of a taxable item (*e.g.*, lumber) for resale is exempt from sales and use tax.[7] The resale exemption covers taxable items sold as-is, or sold as an integral part of a taxable service.[8] Therefore, a contractor who purchases materials for a separated contract may give a resale certificate to its vendor in lieu of paying sales tax when buying the materials. In this instance, the contractor will resell the materials to its customer and collect sales tax. The contractor must transfer care, custody and control of the materials to its customer in order to claim the resale exemption.[9]

Cleaning, Restoring, and Repairing Tangible Personal Property.

Disaster victims, like Bubba, may claim a sales tax exemption on separately-stated charges for labor to repair tangible personal property- such as furniture or appliances- damaged by the disaster.[10] The exemption also applies to labor charges to launder or dry clean damaged clothes or property.[11]

However, the exemption does not extend to materials. Under a separated contract, the customer owes tax on charges for materials. If the repairman fails to separately-state the labor charge, then the entire charge is taxable.[12]

To claim the exemption from tax on labor, the owner must give a completed exemption certificate to the repairman. The certificate must show both the repairman's and the customer's names, the items being repaired, and include the reason for claiming the exemption.

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7 *See* Tex. Tax Code § 151.006(a)(1).

8 *See id.*

9 *See Clearview Cable v. Sharp*, 960 S.W.2d 424 (Tex. App.—Austin, 1998).

10 Comptroller Rule § 3.292(g)(1); Comptroller Rule § 3.357(d)(9); Comptroller Publication No. 94-182, *Disasters and Texas Sales Tax* (April 2006), available at: https://comptroller.texas.gov/taxes/publications/94-182.php#faq3;

11 Comptroller Rule § 3.310(h).

12 Comptroller Rule § 3.292(g)(1); Comptroller Rule § 3.357(d)(9); Comptroller Publication No. 94-182, *Disasters and Texas Sales Tax* (April 2006), available at: https://comptroller.texas.gov/taxes/publications/94-182.php#faq3.

> Cleaning & Restoration Services ("CRS") removes a refrigerator from Bubba's market, takes it back to its warehouse, and repairs the electrical components. CRS sends Bubba a bill with separately-stated charges for labor to repair the refrigerator and the cost of the new wiring used. In lieu of paying sales tax on the labor charge by CRS, Bubba may give CRS a completed exemption certificate that states: "Repair of appliance due to Hurricane Harvey in Aransas County."[13] Since the exemption does not extend to materials, CRS must collect sales tax from Bubba on the separately-stated charge for the new wiring. CRS, in turn, should not pay sales tax on its purchase of the wiring. Instead, CRS should give a resale certificate to the vendor when it buys the wire.

Removing and Discarding Waste.

Charges for removing and disposing of debris or other waste, such as destroyed furniture, in a disaster area are taxable as waste removal services.[14]

> CRS hauls away and disposes of the furniture and contents from Bubba's home and market that cannot be salvaged. CRS must charge sales tax on the full charge for this service.

Landscaping.

Arborists' services, such as cutting down or cutting up a damaged or dead tree in a declared disaster area, are not taxable.[15] However, charges to haul away branches, limbs, or trees are considered taxable waste removal services.[16]

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[13] *See id.*

[14] *See* Comptroller Rule § 3.356.

[15] Comptroller Publication No. 94-182, *Disasters and Texas Sales Tax* (April 2006), available at: https://comptroller.texas.gov/taxes/publications/94-182.php#faq3.

[16] *See id.*

To claim the exemption from sales tax on qualifying labor charges, the owner must provide a completed exemption certificate to the seller. The certificate must include both the seller's and the owner's (purchaser's) names and addresses, a description of the type of arborist services performed, and a description of the reason for claiming the exemption.[17]

> Bubba hires Arborists Plus to cut down and remove the damaged tree that fell on his home. To claim the exemption from sales tax on the charges for cutting down the damaged tree, Bubba should give a certificate to Arborists Plus that states: "Service to cut down a damaged tree due to declared natural disaster in Aransas County."[18] Arborists Plus's separately-stated charges to haul away the branches from Bubba's tree are taxable.

Contractors should separately state charges for taxable and nontaxable services because the law allows the Comptroller to presume that a single charge for taxable and nontaxable services is entirely taxable if the taxable portion is greater than five percent (5%) of the total charge.[19]

> If Arborists Plus bills a single amount to Bubba for both cutting down the damaged tree and hauling away the tree limbs, then the Comptroller may presume that the entire charge is taxable if the service to haul away the tree limbs is greater than 5% of the total bill.

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[17] *See id.*

[18] *See id.*; *See* Texas Comptroller of Public Accounts, *Declared Natural Disasters and Emergencies Tax Help*, comptroller.texas.gov, available at: https://comptroller.texas.gov/taxes/resources/disaster-relief.php.

[19] *See id.*

Demolition.

Charges for the complete demolition and partial demolition of residential structures are not taxable.[20] In addition, charges for the complete demolition of an existing non-residential structure are not taxable.[21] In declared disaster areas, an owner may also claim an exemption for otherwise taxable labor charges incurred to partially demolish non-residential structures.[22]

> When Bubba realizes that the storage building behind his market cannot be salvaged, he hires a demolition contractor named Demos-R-Us to demolish the building. Bubba also hires Demos-R-Us to partially demolish a damaged area of the kitchen in his market. Technically, only the partial demolition of the kitchen requires an exemption certificate for Demos-R-Us to forego collecting tax from Bubba because the complete demolition of the shed is non-taxable. However, Demos-R-Us should obtain an exemption certificate covering both activities to avoid audit issues.

Rebuilding Nonresidential Structures.

Special exemptions apply to construction work performed on nonresidential structures in declared disaster areas. Non-residential structures are properties like restaurants, stores, and office buildings; they are not family dwellings.[23]

In a declared disaster area, property owners may claim an exemption from sales tax on separately-stated charges for otherwise taxable labor to repair, remodel, or restore non-residential structures damaged by the disaster.[24] Charges for the materials used to perform

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20 *See* Comptroller Hearing No. 101,913 (STAR 201012948H) (2010).

21 *See* Comptroller Rule § 3.357(a)(11).

22 Comptroller Publication No. 94-187 (February 2006) (STAR No. 200602645L).

23 *See generally* Comptroller Rule § 3.357 for the definition of "residential" property. Non-residential properties are properties that do not fit under the definition of "residential."

24 Comptroller Publication No. 94-182, *Disasters and Texas Sales Tax* (April 2006), available at: https://comptroller.texas.gov/taxes/publications/94-182.php#faq3.

the repairs are taxable. To claim the exemption on the labor charge, the property owner should give the contractor a completed exemption certificate.[25]

If a contractor working in a declared disaster area charges a lump-sum price for both labor and materials, the entire charge is taxable.

> Bubba hires Quick-Rebuild to repair and remodel the shrimp market, a non-residential structure, under a lump-sum contract. Quick-Rebuild tears the market down to the studs and begins rebuilding the wiring, sheet rock, and floors. If Quick-Rebuild charges Bubba a lump-sum charge for both labor and materials, Quick-Rebuild must charge and collect sales tax on the full amount. But, if Quick-Rebuild's contract separately-states the materials and labor charge, then Bubba may give Quick-Rebuild an exemption certificate in lieu of paying tax on the labor charge.

Rebuilding Residential Structures.

"Residential structures" means family dwellings, including apartment complexes, nursing homes, condominiums, and retirement homes.[26] The labor to repair, remodel, or restore residential real property is nontaxable.[27]

Charges for materials incorporated into the repair, remodel, or restoration of residential real property are taxable.[28] Therefore, a contractor must collect tax from his customer on separately-stated charges for materials. But, if the contractor bills lump-sum, then the contractor should not charge tax on any portion of the contract price; instead, he should pay sales tax when he purchases the materials.

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25 *See id.*

26 *See id.*

27 Comptroller Publication No. 94-116, *Real Property Repair and Remodeling* (94-116); *See* Comptroller Rule § 3.357.

28 *See* Comptroller Rule § 3.291.

> Bubba's home is a residential structure. Bubba hires Fast-Repair to repair and remodel his partially-destroyed home under a time and materials contract. Fast-Repair tears the house down to the studs and replaces the wiring, plumbing, and sheetrock. Because a time and materials contract is treated as a separated contract, Fast-Repair should not charge sales tax on labor charges to repair Bubba's home. However, Fast-Repair must charge sales tax on the price of materials incorporated into the remodel because the law views Fast-Repair as having sold the materials to Bubba. As a result, Fast-Repair can provide a resale exemption certificate when it purchases the materials from its vendor that it will resell to Bubba.

Performing Work for Exempt Entities.

Contractor should be aware of sales tax exemptions available to certain entities, such as governmental entities and religious, educational, and public service organizations.[29] This article focuses on governmental entities, who may prove their entitlement to the exemption with less documentation.[30] Specifically, most exempt entities are required to prove their exempt status by providing an exemption certificate plus a letter of sales and use tax exemption from the Comptroller that is addressed to the entity.[31] However, written contracts or purchase orders that are issued by governmental entities are acceptable documentation of exempt contracts.[32] Notwithstanding, best practices for documenting work for an exempt governmental entity include requesting an exemption certificate and proof of exempt status letter, if available, due to the penalty for incorrectly claiming the exemption. If the Comptroller subsequently determines that an organization is not exempt, then the contractor is liable for all taxes, penalties, and interest that accrue upon the purportedly exempt entity's purchase.[33]

But, if the exemption is properly documented, contractors performing construction services for governmental entities should not charge the customer any tax and are not

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29 *See* Tex. Tax Code §§ 151.309 and 151.310.

30 *See* Comptroller Rule § 3.2919(c)(1); Comptroller Rule § 3.322(c).

31 *See* Comptroller Rule § 3.291(c)(1)-(2)(A); Comptroller Rule § 3.322(b).

32 *See* Comptroller Rule § 3.2919(c)(1).

33 *See* Comptroller Rule § 3.291(c)(2)(A).

required to pay tax on purchases of materials that are incorporated into the realty, completely consumed items necessary and essential to the contract, or taxable services expressly required by and integral to the contract.[34] An item is "completely consumed" if after being used once for its intended purpose, the item is used up or destroyed.[35] When making permissible tax-exempt purchases, the contractor must provide its vendors with an exemption certificate that identifies the contractor as the purchaser, the exempt entity for which the work is performed, and the project for which the items are being purchased.[36] A contractor may give a completed resale certificate when purchasing materials that will be incorporated into the customer's realty under a separated contract.[37]

> Quick-Rebuild enters into a contract with the Port Authority, a governmental entity, to repair the damaged dock where Bubba keeps his boat. When Quick-Rebuild purchases lumber, nails, and supplies either to be incorporated into the dock or completely consumed during the project. It may provide its vendors an exemption certificate that identifies Quick-Rebuild as the purchaser and that the work is a Hurricane Harvey repair project performed for the Port Authority. Quick-Rebuild should not collect sales tax from the Port Authority for its construction work, whether billed lump-sum or separated, if a written contract or purchase orders identify the Port Authority as the customer. Although, it would be wise for Quick-Rebuild to request a properly completed exemption certificate and Comptroller letter confirming its customer's exempt status to avoid audit issues.

Out-of-State Businesses Performing Disaster or Emergency-Related Work in Texas.

An out-of-state business entity that enters Texas at the request of an in-state business under a mutual assistance agreement, or that is an affiliate of an in-state business entity, is exempt

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34 *See* Tex. Tax Code § 151.311(a) and (b); *See* Comptroller Rule § 3.291(c)(4)(A) and (B).

35 *See* Tex. Tax Code § 151.311(d).

36 *See* Comptroller Rule § 3.291(c)(5).

37 *Id.*

from Texas licensing and registration requirements if its business in Texas is limited to performing disaster- or emergency-related work during a disaster period.[38]

An out-of-state entity will not be considered 'engaged in business' in Texas if the entity's presence in Texas is solely for performing disaster- or emergency-related work during a disaster response period.[39] An out-of-state entity will not be required to collect and remit Texas sales and use tax on its sales or purchases of taxable items sold or transferred to its customers during a disaster response period in Texas.[40] However, the entity will owe sales tax on its purchases of taxable items for its own use.[41]

Record Retention Guidelines.

Sales records including contracts, invoices, and exemption certificates must be kept for a minimum of four years. This applies to all contractors, vendors, subcontractors, repairmen, remodelers, consumers of taxable items, and taxable service providers.

The statute is extended indefinitely when no report is filed, the report is fraudulent or the report omits twenty-five percent (25%) or more of the tax required to be shown due on the report. Businesses undergoing an audit or a challenge to a tax assessment must retain all of the relevant records until the underlying assessment is resolved by settlement or litigation.

Conclusion

The Texas sales and use tax rules applicable to contractors performing work in declared disaster areas are complex and pose potential audit issues for contractors. Martens, Todd, Leonard & Ahlrich regularly represents construction contractors and other members of the construction industry during the audit process and in challenging adverse assessments. For more information, please email Jimmy Martens or Danielle Ahlrich at jmartens@textaxlaw.com or dahlrich@textaxlaw.com or call (512) 542-9898.

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38 *See* Tex. Tax Code § 151.0241; *See* Tex. Bus. & Comm. Code Ch.112.

39 *See* Comptroller Rule § 3.286(a)(4)(J).

40 *See* Texas Comptroller of Public Accounts, *Declared Natural Disasters and Emergencies Tax Help*, comptroller.texas.gov, available at: https://comptroller.texas.gov/taxes/resources/disaster-relief.php.

41 *See id.*

Tax Court Jurisdiction is Not Automatic, and Your Appeal Might Preclude It

BY: MARCUS J. BROOKS[1]

One of the many things separating the IRS from most potential creditors is that the IRS has the ability to assess taxes and collect taxes without having to sue the taxpayer, reduce the liability to an enforceable judgment, and then proceed with collection activities. Subject to affirmative procedural options on behalf of the taxpayer, discussed further below, the IRS can make an assessment of taxes and simply begin collecting, including utilizing its substantial powers of lien and levy. In other words, if the taxpayer just sits there, the IRS can eventually show up and collect without ever having to file or set foot in front of a judge.

The opportunity for a taxpayer to seek pre-payment judicial review in front of the Tax Court covers most potential tax liabilities. Many taxpayers assume that the opportunity for Tax Court jurisdiction and the procedural protections that generally come with it (e.g. a post-petition appeals conference if the matter has not had consideration by appeals, attention from IRS counsel individually assigned to the case, and finally a trial in front of a Tax Court judge) are axiomatic. There are, however, a variety of circumstances in which Tax Court review is not available, and there are even some situations in which the taxpayer may cut off the opportunity for Tax Court review by seeking an appeals conference prior to a collection due process (CDP) hearing.

A recent case out of the Seventh Circuit, *Our Country Home Enterprises, Inc. v Comm'r*, 855 F.3d 773 (7th Cir. 2017), highlights these issues as it takes a methodical walk through what the court refers to as "the abstruse world of federal-tax procedure." The opinion starts with a big picture, macro take of tax procedure. It then winnows down to the question at issue in that case, namely whether a taxpayer was precluded from challenging liability for a penalty (§6707A failure to include reportable transaction information with return) in a CDP hearing because the taxpayer previously challenged its liability in an appeals hearing that did not offer the potential for judicial review. The court answers the question in the affirmative, ostensibly leaving the taxpayer to walk the longer and more expensive road of paying the penalty and eventually filing a refund suit if the taxpayer chooses to challenge the IRS's position.

In so doing, the opinion outlines the difference between (i) taxes and related penalties that are subject to deficiency procedures and consequently an opportunity for Tax Court review prior to assessment and collection and (ii) taxes or penalties which are not subject to the deficiency procedures, i.e. "non-deficiency taxes," which do not provide the taxpayer with an opportunity for Tax Court review prior to assessment and collection. It also underscores some situations in which taxpayers might not want to request an appeal, as doing so may cut off an opportunity for Tax Court review.

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Deficiency Procedures – i.e. Notice of Deficiency and Potential for Tax Court Review

The court observes that Congress enacted sections 6212 and 6213 to prohibit the IRS from assessing a deficiency in income, estate, gift, and certain excise taxes until the IRS issues a notice of deficiency, giving the taxpayer access to Tax Court. A taxpayer then has 90 days (or 150 days if he lives outside the United States) to petition the Tax Court for review.

If the taxpayer does not timely file a petition in Tax Court after having received a notice of deficiency, the IRS can assess (or formally record) the deficiency under section 6203. The assessment "is given the force of a judgment," authorizing the IRS to collect the tax. *Bull v. United States*, 295 U.S. 247, 260, 55 S. Ct. 695, 79 L. Ed. 1421, 81 Ct. Cl. 974, 1935-1 C.B. 310 (1935); *Matter of Carlson*, 580 F.2d 1365, 1368 (10th Cir. 1978).

Within 60 days of an assessment, the IRS must notify the taxpayer of the amount due and demand payment. I.R.C. §6303(a). Failure by the IRS to follow the appropriate procedures regarding notice could result in invalidation of a lien or levy. If the taxpayer fails to pay what is due, the IRS can file a notice of federal tax lien, which places a lien on all of the taxpayer's property. I.R.C. §6321. The IRS can also levy on a taxpayer's property, after giving the taxpayer 30 days prior notice. I.R.C. §6331. Finally, the IRS may commence a civil case for collection purposes. *Anuforo v. Comm'r*, 614 F.3d 799, 805 (8th Cir. 2010).

Certain Taxes Not Subject to Deficiency Procedures

Some taxes are not considered deficiencies under the Internal Revenue Code. Certain penalties are, by statute, explicitly exempted from deficiency procedures. *Smith v. Comm'r*, 133 T.C. 424, 428 (2009).[2] Other penalties, such as reporting penalties imposed for failing to report participation in various tax-shelter transactions, have been found to be exempt from deficiency procedures based upon fact that the Tax Court is a court of limited, statutory jurisdiction and an analysis of the penalty at issue. *Smith*, 133 T.C. at 429 (finding section 6707A taxes to be exempt from deficiency procedures).[3] *Our Country Home* notes that, for these non-deficiency taxes,

[2] Internal citation to sections 6677(e) (failure to file information with respect to foreign trust), 6679(b) (failure to file returns, etc., with respect to foreign corporations or foreign partnerships), 6682(c) (false information with respect to withholding), 6693(d) (failure to provide reports on certain tax-favored accounts or annuities), 6696(b) (rules applicable with respect to secs. 6694, 6695, and 6695A), 6697(c) (assessable penalties with respect to liability for tax of regulated investment companies), 6706(c) (original issue discount information requirements), 6713(c) (disclosure or use of information by preparers of returns), 6716(e) (failure to file information with respect to certain transfers at death and gifts).

[3] Internal citations to *Shaw v. United States*, 331 F.2d 493 (9th Cir. 1964) (distinguishing section 6672 penalties not subject to deficiency proceedings from section 6651 additions subject to deficiency proceedings); *Medeiros v. Comm'r*, 77 T.C. 1255 (1981) (this Court lacks jurisdiction to review previously assessed section 6672 penalties), affd. 742 F.2d 1446 (2d Cir. 1983); *Judd v. Comm'r*, 74 T.C. 651 (1981) (this Court lacks jurisdiction to review assessment of section 6652 additions to tax).

which are not subject to deficiency procedures like prepayment judicial review in Tax Court,[4] the IRS can make an immediate assessment.

Collection Due Process Hearings – Procedure and Scope

Prior to 1998, the IRS could reach a delinquent taxpayer's assets by lien or levy providing any sort of pre-attachment process or judicial oversight. In response to concerns about this expansive collection power without judicial oversight, Congress enacted sections 6320 and 6330, granting a taxpayer the right to a CDP hearing within the IRS Office of Appeals after the IRS issues a notice of federal tax lien (§6320) or before the IRS levies on the taxpayer's property (§6330).

Importantly, pursuant to section 6330(d)(1), a taxpayer who disagrees with the Appeals Office's decision in a CDP hearing can appeal that decision to Tax Court. When the issue involves liability for the penalty, the Tax Court reviews the Appeals Office's determination *de novo*. *Goza v. Comm'r*, 114 T.C. 176, 181–82 (2000). However, that Tax Court review is only available for items that were at issue in the CDP hearing. Taxpayers or their representatives can be forgiven for often being confused about what may or may not be raised in a CDP hearing, as it is situation specific and even depends upon the type of tax at issue. To wit:

- A taxpayer may raise "any relevant issue relating to the unpaid tax or the proposed levy," including collection alternatives and challenges to the proposed collection action unless "the issue was raised and considered at a ... previous administrative or judicial proceeding" and the taxpayer 'participated meaningfully' in that proceeding." I.R.C. § 6330(c)(2)(A) & (c)(4)(A).[5]

- A taxpayer may also challenge liability for the tax, but only if the taxpayer "did not receive any statutory notice of deficiency for such tax liability or did not otherwise have an opportunity to dispute such tax liability." I.R.C. § 6330(c)(2)(B).

    - "An opportunity to dispute the underlying liability includes a prior opportunity for a conference with Appeals that was offered either before or after the assessment of the liability." Treas. Reg. § 301.6330-1(e)(3) Q&A-E2.

    - However, "[a]n opportunity for a conference with [the] Appeals [Office] prior to the assessment of a tax subject to deficiency procedures is not a prior opportunity for this purpose." *Id*.

In *Our Country Home*, the court affirmed the Tax Court's refusal to entertain liability arguments by the taxpayer because the taxpayer had previously participated in an appeals conference. Even

[4] *See* Internal Revenue Manual §8.17.7.1.1 ("When the Tax Court Lacks Jurisdiction") and internal cites therein for information regarding which penalties the IRS views as being outside Tax Court jurisdiction.

[5] It is worth noting that the IRS formerly interpreted section 6330(c)(4)(A) not to apply to liability issues in light of Section 6330(c)(2)(B)'s explicit discussion on that point. *See* Office of Chief Counsel, Internal Revenue Serv., Notice CC-2003-016, at 20 (2003). But the IRS's current interpretation, affirmed in *Our Country Home* and other cases cited *infra*, simply restates the statutory language. See Office of Chief Counsel, Internal Revenue Serv., Notice CC-2006-019, at 33 (2006).

though no judicial review had been available from the appeals conference, the court, upholding the pertinent regulations under a *Chevron* deference analysis, held that this presented two separate prohibitions for the taxpayer, even though there had been no opportunity for judicial review of that appeals conference: (i) a prior opportunity to argue liability and (ii) a prior conference in which the taxpayer meaningfully participated. This reading, upheld by the Seventh Circuit here, has also been recently upheld by the Tax Court and the Fourth Circuit.[6]

Section 6330 and the IRS's interpretation of the regulations, supported by the court in *Our Country Home*, raise some risks and considerations for taxpayers who would prefer the opportunity for Tax Court review (i.e. for any judicial review prior to collection). They also present some different and significant procedural considerations for taxpayers in a deficiency context versus taxpayers presented with a non-deficiency case.

<u>Considerations Relating to Non-Deficiency Taxes</u>

With respect to non-deficiency taxes, the regulations provide that any opportunity to go to appeals precludes consideration of liability at a CDP hearing. This means that, for non-deficiency taxes, taxpayers should be aware if they are provided an opportunity for an appeals conference prior to collections and a CDP hearing, they may not have an opportunity for judicial review unless they pay the amount and sue for a refund.[7] Pre-collection appeals opportunities are not provided in every non-deficiency case. This raises the somewhat perverse incentive for a taxpayer to hope against a pre-collection appeals conference, and certainly not to raise the issue lest they be offered such a hearing in a pre-CDP context which provides no opportunity for Tax Court review. If the taxpayer's first opportunity for an appeals hearing is in the CDP context, then Tax Court review of liability should be available. Pursuant to the IRS's reading of the regulations, upheld in dicta by the Seventh Circuit in *Our Country Home*, for non-deficiency cases this would be the taxpayer's only opportunity for pre-collection judicial review.

<u>Considerations Relating to Deficiency Cases</u>

With respect to taxes subject to the deficiency procedures, however, the opportunity for a pre-assessment appeals conference does not constitute a prior opportunity under the regulations. Nevertheless, it is still the case that CDP consideration of liability is unavailable under section 6330(c)(4)(A) if "the issue was raised and considered at a ... previous administrative or judicial proceeding" and the taxpayer "participated meaningfully" in that proceeding. Therefore, where a taxpayer in a deficiency case is presented with an opportunity for appeals, but for some reason

6 *E.g.*, *Durda v. Comm'r*, T.C. Memo 2017-89 (where taxpayer disputed the tax liabilities in a prior appeals hearing, §6330(c)(2)(B) barred him from contesting those liabilities during the CDP process); *Iames v. Comm'r*, 850 F.3d 160, 165 (4th Cir. 2017) (finding the regulation to be a "straightforward interpretation of [s]ection 6330(c)(2)(B)").

7 In *Our Country Home*, the Seventh Circuit stated: "Section 6330(c)(2)(B) speaks to opportunities to dispute liability, not opportunities that a taxpayer actually exercised. … Thus, a taxpayer need not pursue that opportunity to be barred from raising a liability challenge in a CDP hearing." 855 F.3d at 788.The Tax Court itself has not yet had to squarely answered the question of whether just the offer of an Appeals conference is enough to preclude review in a subsequent CDP proceeding if the taxpayer declined the offer. *See Bitter v. Comm'r*, T.C. Memo. 2017-46, at footnote 6 (declining to address the question and citing to *Lewis v. Comm'r*, 128 T.C. 48, 61 n.9 (2007); but also citing *Thompson v. Comm'r*, T.C. Memo. 2012-87 for the proposition that "[a] taxpayer has the opportunity to dispute his liability for a trust fund recovery penalty when he receives a Letter 1153" offering an appeals conference). This at least leaves open an opportunity to decline the appeals conference and argue that a CDP hearing and Tax Court review should still be available. However, the Seventh Circuit's opinion and Tax Court dicta raise questions about the strength of this argument.

did not receive a statutory notice of deficiency or did not receive one in time to file a Tax Court petition,[8] that taxpayer may still have the opportunity for judicial review through a CDP hearing. If, however, the taxpayer had "meaningfully participated" in a prior appeals hearing, then the taxpayer has run into a separate prohibition. If the taxpayer had instead foregone participating in an appeals conference at that time, an appeals conference would likely be provided later, after the taxpayer had filed a Tax Court petition, without threatening the potential for Tax Court review on a CDP hearing. . While this is probably an insufficient reason, standing alone, to forego pre Tax Court petition appeals, it is at least one consideration when determining whether to request appeals pre-Tax Court petition or whether to forego appeals until after the Tax Court petition has been filed.

Conclusion

Taxpayers should be aware that Tax Court review is not axiomatic. When it is unavailable, or has been foregone, it leaves the taxpayer in the position of having to pay the tax and seek a refund in order to seek judicial review of the IRS's determinations.

In deficiency cases, Tax Court review should be made available either pre-assessment or in a CDP hearing. However, if for some reason a notice of deficiency is not received in time for the taxpayer to seek Tax Court review, the taxpayer's participation in a pre-assessment appeals conference might ultimately preclude pre-collection review by the Tax Court. In non-deficiency cases, Tax Court review may only be available if the taxpayer pursues a CDP hearing and has not previously had the opportunity for an appeals hearing. An early awareness of these rules, and the identity of your case as a deficiency or non-deficiency case, is necessary in order to (i) set appropriate client expectations, (ii) make the appropriate strategic calls early in a case to save time/resources, and (iii) not accidentally forfeit the opportunity for Tax Court review.

[8] Treas. Reg. § 301.6330-1(e)(4) Example 2.

Current Tax Relief Available for Victims of Hurricane Harvey

by Jeffry M. Blair[1]

Hurricane Harvey was one of the most devastating and destructive hurricanes to ever hit the United States. Since first coming ashore on August 25, 2017, Hurricane Harvey has killed an estimated 50 people, displaced more than 1 million and damaged some 200,000 homes in its path of destruction.[2] Texas Governor Gregg Abbott estimated that the cost for reconstruction for the damages left in the storm's wake could reach $180 billion.

To cope with this disaster, the federal government has stepped in to provide certain tax relief. Some of this tax relief became available when the area damaged by Hurricane Harvey was declared a national disaster by President Trump. Other tax relief required legislation by Congress. In this article, I have tried to briefly summarize some of the tax relief that is currently available and the tax implications of that relief.

CURRENT TAX RELIEF AVAILABLE

On Friday, August 25, 2017, President Donald Trump signed a disaster declaration with respect to certain areas within the State of Texas. This declaration permitted the Federal Emergency Management Agency ("FEMA") to initially designate the following 18 counties in Texas as federal disaster areas qualifying for individual assistance: Aransas, Bee, Brazoria, Calhoun, Chambers, Fort Bend, Galveston, Goliad, Harris, Jackson, Kleberg, Liberty Matagorda, Nueces, Refugio, San Patricio, Victoria and Wharton. FEMA later designated the following additional 21 counties in Texas as federal disaster areas: Austin, Bastrop, Colorado, DeWitt, Fayette, Gonzales, Hardin, Jasper, Jefferson, Karnes, Lavaca, Lee, Montgomery, Newton, Orange, Polk, Sabine, San Jacinto, Tyler, Walker and Waller.[3] FEMA's designation permits victims of Hurricane Harvey in these Texas counties to receive certain federal tax relief.

A. Tax Relief through the Exclusion of Certain Items from Taxable Income

During the period following a disaster, victims of that disaster often receive various forms of relief in the form of government subsidized loan, gifts and other types of payments. Since most of this relief is meant to just help return disaster victims to the place they were prior to the disaster, the tax consequences of the receipt of some of these benefits can be important. Gross income is generally defined very broadly to include all income from whatever source

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[2] *Hurricane Harvey Damages Could Cost up to $180 Billion*, FORTUNE, Sept. 3, 2017.

[3] FEMA also designated the following counties for public assistance: Bexar, Burleson, Dallas, Grimes, Tarrant, Travis, and Washington. *See https://www.fema.gov/disaster/4332*.

derived unless specifically excluded under the Internal Revenue Code.[4] However, certain disaster relief is specifically excluded from gross income enabling disaster victims to receive this relief on a tax-free basis.

1. <u>Disaster Loans</u>

Most federal assistance to individual disaster victims comes through low interest, federally subsidized loans.[5] These types of loans can help provide funds to repair damaged homes not covered by insurance. In general, loan proceeds do not represent taxable income as long as the borrower is required to repay the loan. In addition, low interest loans to disaster victims are exempt from the imputed interest rules of Section 7872 of the Code provided that the loans are subsidized by the federal, state, or municipal government (or any agency or instrumentality thereof) and are made available under a program of general application to the public.[6] Accordingly, most individual disaster victims of Hurricane Harvey will be able to receive this type of aid without negative tax impact.

2. <u>Gifts</u>

Victims of Hurricane Harvey may also receive gifts from friends, family members, charities and even warm hearted strangers with the intent to help these victims get back on their feet. If these payments are treated as "gifts" within the meaning of Section 102 of the Code, then the disaster victims will not have to include these amounts in their taxable income.

Although neither the Code nor the Treasury Regulations specifically define the term "gift", the Supreme Court has indicated that a gift "must proceed from a detached and disinterested generosity … out of affection, respect, admiration, charity or like impulses."[7] The Internal Revenue Service ("IRS") has indicated that payments from a charity to an individual that responds to an individual's needs and does not proceed from any moral or legal duty, are treated as proceeding from a detached and disinterested generosity.[8] Accordingly, payments from a charity to individuals affected by disasters that are for medical, temporary housing, and transportation expenses incurred by such individuals as a result of a flood are generally treated as gifts because these payments do not proceed from any moral or legal duty and are motivated by detached and disinterested generosity.[9] The IRS has also indicated that payments from a fund that was formed with public donations in response to the outpouring of public support for victims of a tragedy and their families should be treated as non-taxable gifts to the recipients because the

[4] All section references are to the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise stated.

[5] *See*, *e.g.*, FEMA's website for victims of Hurricane Harvey at https://www.fema.gov/disaster/4332 under the subheading of "After You Apply for Assistance."; Help After a Disaster at https://www.fema.gov/media-library/assets/videos/74764# .

[6] Prop. Reg. §1.7872-5(b)(5).

[7] *Commissioner v. Duberstein*, 363 U.S. 278, 285 (1960).

[8] Rev. Rul. 99-44, 1999-2 C.B. 549.

[9] Rev. Rul. 2003-12, 2003-1 C.B. 283 (stating that relief grants received by recipients in a "presidentially declared disaster area" .

payments were made out of concern for the victims' needs and not from any moral or legal duty.[10]

Not all such grants, however, will be excludable as gifts. Government grants will normally not qualify as gifts because the government is acting out of duty rather than generosity.[11] In addition, payments from employers to employees in connection with a disaster will also not be treated as gifts because these payments do not proceed from a detached and uninterested generosity.[12] Accordingly, to be excluded from the victim's taxable income, government and employer distributions must qualify under a different exclusion.

3. Disaster Relief Payments

One possible exclusion is Section 139 of the Code. In general, payments received by individuals as a result of, in connection with or otherwise attributable a natural disaster will not be treated as taxable income of the individual receiving the payment if the payment is treated as a "qualified disaster relief payment" within the meaning of Section 139 of the Code.[13]

Section 139 of the Code defines the term "qualified disaster relief payment" very broadly. For purposes of this exemption, a "qualified disaster relief payment" is defined as any amount paid to or for the benefit of an individual:

(a) to reimburse or pay reasonable and necessary personal, family, living or funeral expenses incurred as a result of a qualified disaster;

(b) to reimburse or pay reasonable and necessary expenses incurred for the repair or rehabilitation of a personal residence or repair or replacement of its contents to the extent that the need for such repair, rehabilitation, or replacement is attributable to a qualified disaster;

(c) by a person engaged in the furnishing or sale of transportation as a common carrier by reason of the death or personal physical injuries incurred as a result of a qualified disaster; or

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[10] Information Letter 2013-0020 (May 22, 2013).

[11] Rev. Rul. 2005-46, 2005 IRB (disaster relief grants by state program to qualifying business was not exempt as a gifts under Section 102 of the Code); Rev. Rul. 2003-12, 2003-1 C.B. 283 (relief grants received by individuals under a state's program to pay or reimburse medical, housing, or transportation needs incurred due to disaster did not qualify as a gift under Section 102 of the Code); Notice 2003-18, 2003-1 C.B. 699 Q&A 3, 2003-14 IRB 699 (government grants to businesses under World Trade Center Grant Programs do not qualify for the gift exclusion under Section 102 of the Code because the intent of the federal, state and local governments in making these payments proceeds, not from charity or detached and disinterested generosity but from the government's duty to relieve the hardship resulting from the disaster).

[12] Rev. Rul. 2003-12, 2003-1 C.B. 283 (indicating that grants to pay or reimburse medical, housing, or transportation needs incurred due to a disaster made by employer to employees do not qualify for exclusion as a gift but will qualify for exemption under Section 139 of the Code).

[13] §139(a).

(d) if such amount is paid by a Federal, State or local government or agency or instrumentality thereof, in connection with a qualified disaster in order to promote the general welfare,

but only to the extent any expense compensated by such payment is not otherwise compensated for by insurance or otherwise.[14]

For purposes of Section 139, the term "qualified disaster" includes any disaster determined by the President of the United States to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act.[15] Hurricane Harvey qualifies as a "qualified disaster" under this definition.

Based on these broad definitions, many, if not most, reimbursements or payments received by individuals who are victims of Hurricane Harvey to compensate them for their expenses incurred as a result of Hurricane Harvey will be exempt from taxation under Section 139 of the Code to the extent that such payments are not otherwise compensated by insurance or otherwise. Employers seeking to help their employees through payments to such employees for unreimbursed expenses generally can structure these payments to qualify these payments for exemption from income inclusion under Section 139 of the Code. In addition, the legislative history of Section 139 of the Code indicates that the employer will still be permitted a deduction for these payments even though the employee is able to exclude these payments from gross income.[16] This permits employers to provide needed relief to its employees who were disaster victims while still getting a deduction for these payments.

There are certain exceptions to Section 139 that employers and victims of Hurricane Harvey should keep in mind. First, Section 139 only applies to payments to individuals.[17] In addition, the exclusion from taxable income applies only to the portion of any such payment that represents the reimbursement for covered expenses that has not already been reimbursed by insurance or otherwise.[18] Furthermore, the individual for whose benefit a qualified disaster relief payment is made can't claim a tax deduction or tax credit for, or by reason of, an expenditure to the extent of the amount excluded from income under Section 139 of the Code with respect to such expenditure.[19] Moreover, Section 139 does not exclude payments received in lieu of lost compensation or lost business profits.[20]

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[14] §139(b).

[15] §139(c)(2) (i.e. a federal disaster as defined by former §165(h)(3)(C)(i) before amended by Sec. 221(a)(27)(A) DivA, PL 112-295, Dec. 19, 2014); *see also* the current definition of Federally declared disaster area found in §165(i)(5)(A) (same definition).

[16] *See* Joint Committee on Taxation Staff, Technical Explanation of Victims of Terrorism Tax Relief Act of 2001 (JCX-93-01), Dec. 21, 2001, p.16.

[17] §139(a). Even though businesses cannot use the exclusion from income under Section 139, to the extent that the business is able to deduct the underlying expenditures , the net effect on the businesses taxable income will be zero.

[18] §139(b) flush language.

[19] §139(h).

[20] *See* §85 (stating that unemployment compensation is included in gross income); Notice 2003-18, 2003-1 C.B. 699 Q&A 2, 2003-14 IRB 699 (government grants to businesses under World Trade Center Grant Programs that compensate for lost profits or business income (whether to individuals or businesses), do not qualify for exclusion under the general welfare exclusions).

B. Tax Relief through the Extension of Due Dates on Tax Returns

On August 28, 2018, the IRS announced on its website that it was extending the deadlines for filing certain tax returns and paying certain taxes with due dates falling on or after August 23, 2017 for victims of Hurricane Harvey (in counties in Texas that are designated by FEMA as federal disaster areas qualifying for individual assistance).[21] This relief gives disaster victims needed addition time to file tax returns that would otherwise be required to be filed during the period immediately after are the hurricane caused such devastation.

This relief is available only to taxpayers considered to be "affected taxpayers." In general, the term "affected taxpayer" is defined to include: (i) any individual whose principal residence, and any business entity or sole proprietor whose principal place of business is located in the counties designated as disaster areas; (ii) any individual who is a relief worker assisting in a covered disaster area, regardless of whether he or she is affiliated with recognized government or philanthropic organizations; (iii) any individual whose principal residence or business entity or sole proprietor whose principal place of business is not located in a covered disaster area but whose records necessary to meet a filing or payment deadline are maintained in a covered disaster areal (iv) any estate or trust that has tax records necessary to meet a filing or payment deadline in a covered disaster area; and (v) any spouse of an affected taxpayer, solely with regard to a joint return of the husband and wife.[22]

Tax returns that may be postponed include (a) individual, corporate and estate and trust income tax returns, (b) partnership returns, S corporation returns and trust returns; (iv) generation-skipping transfer tax returns; (v) employment and (vi) certain excise tax returns. In general, the filing date postponement does not apply to information returns on forms W-2, 1098 or 1099 or to IRS Forms 1042 or 8027. However, taxpayers may still apply for relief from penalties for failure to timely file these returns under current procedures for establishing a "reasonable cause" for the delay.

In general, the tax relief postponed various tax filing and payment deadlines that occurred starting on August 23, 2017. As a result, affected individuals and businesses will have until January 31, 2018 to file certain income tax returns and pay taxes that were originally due during this period. For affected taxpayers, the deadlines for filing tax returns and paying taxes impacts a variety of returns, including the following:

<u>Individuals</u>

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[21] IR-News Rel. 2017-135 (Aug. 28, 2017). Section 7508A of the Code indicates that if a taxpayer is affected by a federally declared disaster (as defined by section 165(h)(3)(C)(i) of the Code), the Secretary of the Treasury may specify a period of up to one year that may be disregarded in determining under the internal revenue laws, in respect of any tax liability of taxpayer for timely filing returns, the amount of interest or penalty and additional tax amounts to be assessed and the amount of any credit or refund. §7508A(a)

[22] Treas. Reg. §301.7508A-1(d)(1). The term "affected taxpayer" also include any individual visiting the covered disaster area who was killed or injured as a result of the disaster and any other person determined by the IRS to be affected by a federally declared disaster (within the meaning of §1033(h)).

- *Estimated Tax Payment*. The deadline for filing estimated individual tax payments for September 15, 2017 and January 15, 2018 was extended to January 31, 2018.

- *Validly Extended 2016 Federal 1040.* The deadline for filing an individual's 2016 federal income tax return with respect to which the individual received a tax-filing extension to October 15, 2017, was extended to January 31, 2018.

Businesses

- *Quarterly Payroll Tax Returns.* The October 31, 2017 deadline for filing quarterly payroll and excise tax returns without penalty due on or after August 23, 2017 and before September 7, 2017 was extended until September 7, 2017.

- *Validly Extended Federal Business Tax Returns.* The due date for affected businesses with valid extensions for their income tax returns that would have run out on September 15, 2017, was extended until January 31, 2018.

Texas State Tax Returns

The Texas State Comptroller also permitted limited temporary extensions of time to file taxes for businesses in federally declared disaster areas. These returns include the following:

- 2017 Franchise tax returns with valid extensions until November 15, 2017 were granted an automatic extension until January 5, 2018. Service providers who file franchise tax reports on behalf of other taxpayers can request a franchise tax extension if the provider is affected by Hurricane Harvey and is located in a county designated by FEMA to be in the federally declared disaster area.

- Sales and Use tax reports for businesses in the federally declared disaster area were given an automatic 30 day extension for filing August monthly reports otherwise due September 20, 2017 and quarterly reports otherwise due on October 20, 2017.

The IRS automatically provides filing and penalty relief to any taxpayer with an IRS address of record located in the disaster area. Taxpayers who live outside the disaster but whose records necessary to meet a deadline occurring during the postponement period are located in the affected area and workers assisting the relief area need to contact the IRS at 866 562-5227.

C. Requests for Prior Tax Returns

Reconstructing tax records after a natural disaster can be an important first step in getting federal assistance or insurance reimbursement. In response to this need, the Internal Revenue Service will generally expedite requests by disaster victims for copies of prior tax returns and will waive normal user fees. To obtain copies of the previous four years of transcripts, taxpayers can file IRS Form 4506, Request for a Copy of Tax Return or IRS Form 4506-T, Request for

Transcripts of a Tax Return. In order to receive expedited processing and waiver of normal user fees, taxpayers should write "Hurricane Harvey" in red at the top of these IRS forms.[23]

D. Casualty Losses

Many of the victims of Hurricane Harvey suffered casualty losses. Claiming those losses will be important to taxpayers as the losses may provide a reduction in taxes for either the current or the prior tax year. In some cases, these losses can provide funds through a refund of taxes paid with respect to the 2016 tax year.

Personal Property

In general, Section 165(c)(3) of the Code permits noncorporate taxpayers a deduction (subject to the limitation of Section 165(h)) for losses of property not connected with a trade or business or a transaction entered into for profit if such losses arose from fire, storm, shipwreck or other casualty.[24] These "casualty losses" permit taxpayers that suffer losses with respect to their personal property as a result of natural disasters such as hurricanes to take a deduction for these losses to the extent that these personal property losses are not covered by insurance or other reimbursements. Normally, taxpayers that suffer a casualty loss must deduct the loss in the tax year in which the loss is incurred.[25] However, affected taxpayers in a federally declared disaster area may elect to take disaster related casualty losses into account on their federal income tax return for taxable year immediately preceding the tax year in which the disaster occurred.[26]

This permits affected taxpayers to amend their previously filed 2016 federal income tax return (or include on their properly extended 2016 federal income tax return) their casualty losses suffered as a result of Hurricane Harvey. These losses could create a tax refund with respect to the taxpayer's 2016 return or reduce the federal income taxes otherwise due on a yet to be filed on a properly extended 2016 return. This tax refund or reduction in taxes otherwise due could help provides the affected taxpayer with greatly needed funds. Casualty losses are reported on IRS Form 4684. Affected taxpayers claiming a disaster loss on a 2016 federal income tax return should put the Disaster Designation "Texas, Hurricane Harvey" at the top of the form so that the IRS can expedite the processing of the return.

Regardless of whether or not an affected taxpayer elects to include a personal casualty loss on the taxpayer's 2016 or 2017 federal income tax return, the nonbusiness casualty losses are generally subject to certain limitations. First, personal casualty losses are allowed only to the extent the amount of each casualty loss exceeds $100 per casualty floor. Second, personal casualty losses are allocated only to the extent that the total net casualty losses (i.e. casualty

[23] *See* Fact Sheet (FS) 2006-7, January 2006 (discussing procedures for reconstructing taxpayer's records after a disaster) (available on the IRS website at https://www.irs.gov/newsroom/reconstructing-your-records).

[24] §165(c)(3). Casualty losses are defined as losses arising from fire, storm, shipwreck or other casualty.

[25] §165(i)(1); Treas. Reg. §1.165-7(a)(1).

[26] *Id.* An affected taxpayer makes the election by deducting the disaster loss on either an original or amended federal tax return for the preceding tax year and by including an election statement with the return. *See* Treas. Reg. §1.165-11T, Rev. Proc. 2016-53, 2016-44 I.R.B. 530 for additional details regarding how to elect to deduct a disaster loss in the prior tax year.

losses in excess of casualty gains) exceed ten percent (10%) of the taxpayer's adjusted gross income.

On September 29, 2017, President Trump signed into law the "Disaster Tax Relief and Airport and Airway Extension Act of 2017 (the "Disaster Relief Act of 2017") providing additional temporary tax relief for victims of Hurricane Harvey. Similar to prior disasters, the Disaster Relief Act of 2017 revised these limitations for deductible personal casualty losses that arise in the Hurricane Harvey disaster area after August 22, 2017 and that are attributable to Hurricane Harvey.[27] Specifically, for net disaster losses arising from Hurricane Harvey: (i) the taxpayer's standard deduction is increased by the amount of his or her "net disaster loss"; (ii) the portion of the standard deduction that is allocable to the net disaster loss is allowed for alternative minimum tax purposes; (iii) the $100 per casualty floor is increased to $500; and (iv) the net casualty loss is not subject to the ten percent (10%) of the taxpayer's adjusted gross income threshold. Although these changes increase the per casualty floor from $100 to $500, the other changes should provide most victims of Hurricane Harvey with a greater ability to deduct their net personal casualty losses.

Condemned Residences

Although many homes will be able to be rebuilt, some may end up being condemned. The taxpayer-owner of a residence that has been rendered unsafe by a disaster in an area determined by the President to warrant assistance under the Robert T. Stafford Disaster Relief and Emergency Assistance Act may treat the demolition or relocation of such residence as a casualty loss under Section 165(i) of the Code.[28] To qualify for this treatment, (i) the taxpayer must be ordered by the government of the state or any political subdivision thereof in which such residence is located, to demolish or relocate such residence, and (ii) the residence must have been rendered unsafe for use as a residence by reason of the disaster.[29] By treating the losses on these condemned residences as casualty losses under Section 165(i) of the Code, taxpayer-owners may elect to deduct the loss in the taxable year proceeding the taxable year in which the demolition or relocation order occurs, subject to the limitations for casualty losses described above.

Businesses

Casualty losses are also permitted with respect to a trade or business. In some ways, business casualty losses are treated more favorably under the Code than personal casualty losses. Business casualty losses are not reduced by the $100 per casualty or the 10% of adjusted gross income limitations, and business casualty losses are deductions to get to adjusted gross income rather than an itemized deduction. However, there are some potential limitations. First,

[27] Section 504(b)(3)(A), Pub. L. 115-63 (September 29, 2017). This Act also provides similar tax relief with respect to deductible personal casualty losses that arise in the Hurricane Irma disaster are after September 3, 2017 and that are attributable to Hurricane Irma or that arise in the Hurricane Maria disaster area after September 15, 2017 and that attributable to Hurricane Maria. *See* Sections 504(b)(3)(B) and (C) of the Disaster Relief Act of 2017. Although most references to the Disaster Relief Act 2017 focus on the provisions for Hurricane Harvey, similar provisions were included in this Act to provide relief for victims of Hurricane Irma and Hurricane Maria.

[28] §165(k).

[29] §§165(k)(1)-(2).

taxpayers must determine each business casualty loss separately for each identifiable piece of property. In addition, losses of investment real property may be subject to the passive loss limitations if the taxpayer owner does not materially participate in the trade or business of the real property.

On the positive side, the election to deduct the casualty losses in the taxable year immediately preceding the year that the casualty loss occurs also applies to business casualty losses. Furthermore, if the casualty loss results in a net operating loss for the business in that preceding tax year, that net operating loss may be carried back for up to an additional two tax years. Effectively, this would permit a taxpayer business affected by Hurricane Harvey to carryback their loss up to three tax years prior to 2017 (i.e. the actual tax year in which the casualty loss occurred).

D. *Casualty Gains*

In addition to casualty losses, property destroyed or damaged as the result of Hurricane Harvey could also result in a taxable gain on the receipt of insurance proceeds or other taxable compensation in exchange for the damaged property. This is especially true if the property has increased in value over its original cost or if it is depreciable property where the tax basis of the property has been depreciated to less than its current fair market value. In these cases, the affected victims of Hurricane Harvey will need to decide whether to recognize the gain or defer it under the rules for involuntary conversions.

Recognition of Gains

If the amounts of insurance compensation or other taxable consideration received by the taxpayer exceed the taxpayer's adjusted tax basis, then the taxpayer will realize a taxable gain in amount equal to such excess.[30] That gain will be have to be recognized and included in the taxpayer's gross income for the year in which the property was destroyed unless a nonrecognition provision applies.[31] If the property was a capital asset then the gain will be capital gain.[32] In addition, personal casualty gains (i.e. casualty gains on property used personally rather than in a trade or business or held for investment) are given a benefit. If an individual taxpayer's personal casualty gains exceed that taxpayer's personal casualty losses for a tax year, then all of that taxpayer's personal casualty gains and personal casualty losses for that tax year will be treated as capital gains and capital losses respectively.[33] Capital gains recognized on property held for more than one year are characterized as long-term capital gains. Long-term capital gains are generally subject reduced federal income tax rates, currently not exceeding twenty percent (20%).[34] Accordingly, if a victim of Hurricane Harvey has a net casualty gain and chooses to recognize that gain, they will normally be taxed as a relatively low federal income tax rate.

[30] §1001(a).
[31] §1001(c).
[32] §1222.
[33] §165(h)(2)(B).
[34] §1(h).

Exclusion of Gain on Home

In addition to a reduced federal income tax rate on long-term capital gains, if a disaster victim loses their principal residence and chooses to recognize the gain or loss on the sale, the taxpayer may be able to reduce or eliminate their taxable gain under Section 121 of the Code. Taxpayers who live in their house as their principal residence for at least two of the last five years may exclude up to $250,000 ($500,000 for married filing jointly) of the gain realized on the sale of that house from gross income. Although this provision is not limited to disaster victims, it can be very beneficial to disaster victims who lose their homes and choose not to roll the insurance proceeds into another home within the time periods required under the involuntary conversion rules. Effectively, it can shelter a portion or all of the current increase in value of their home from tax. In addition, if they plan to be in their replacement home for at least two years, any gain they recognize on that home could also be excluded under Section 121 of the Code.

Electing Involuntary Conversion Treatment

Alternatively, under certain circumstances, a taxpayer may be permitted to defer the recognition of gain under the rules for involuntary conversions. Under these rules, if a property is compulsorily or involuntarily converted (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation, or threat or imminence thereof) into property similar or related in service or use to the property so converted, then no gain shall be recognized on such conversion.[35] Involuntary conversions include the temporary conversion into cash where the taxpayer within a limited time period purchases qualified replacement property.[36] The involuntary conversion rules can permit the victim of a disaster to not have to immediately recognize a sudden and unexpected taxable gain but rather choose to defer that gain until the sale of the replacement property.

In addition to the general involuntary conversion rules, special rules apply to properties damaged by federally declared disasters. Several of these rules apply to taxpayers whose principal residence or any of its contents are damaged, destroyed, or otherwise compulsorily or "involuntarily converted" as a result of a presidentially declared disaster. In that case, no gain is recognized on the receipt of insurance proceeds for personal property that was part of the principal residence that was damaged in the disaster but was not scheduled property for purposes of such insurance.[37] Under general tax rules, taxpayers would normally have to recognize gain or loss on the receipt of insurance proceeds in exchange for the destroyed personal property. Without this provision, the taxpayer arguably would have realized gain to the extent that the insurance proceeds received with respect to this personal property exceeded the taxpayer's tax basis in this property. This would require the taxpayer to prove his or her tax basis of each piece of personal property damaged in order to avoid the recognition of gain with respect to each such piece of property. Even if the taxpayer had kept such detailed records, there is a good chance that those records would have been destroyed or damaged from the flood caused by Hurricane Harvey. Accordingly, this exception to the general rule is important because it relieves taxpayers

[35] §1033(a)(1).
[36] §1033(a)(2).
[37] §1033(h)(1)(A)(i).

from having to try to establish their tax basis with respect to this personal property and permits the any gain with respect to this property to escape immediate gain recognition regardless of whether the taxpayer chooses to reinvests the proceeds with respect to this personal property in similar replacement property or do something else with this money.[38] In addition, although the insurance proceeds for the residence and the scheduled personal property are subject to the usual gain recognition rules, the proceeds for these assets are treated as received for the conversion of a "single item of property."[39] Furthermore, any property that is "similar or related in service or use to the residence so converted (or contents thereof)" is considered similar or related in service or use to this single item of property.[40] Effectively, this treats the proceeds received for the residence and the proceeds received for the scheduled assets as a "common pool of funds" and no efforts are made to ascertain whether the insurance proceeds received for a particular item e.g. a chair) is reinvested in similar or related property (e.g. a new chair). This provides taxpayers with flexibility in determining how best to replace the residence and scheduled property. Moreover, the replacement period for this single item of property is extended to 4 years after the close of the taxable year during which gain is first realized as a result of the conversion rather than the usual two year period.[41]

There is also a special rule for trade or business property that is involuntarily converted as a result of a disaster. If a taxpayer holds property for productive use in a trade or business or for investment and that property is located in a disaster area and that property is involuntarily or compulsory as a result of a Presidentially declared disaster area, then any "tangible property of a type" held for productive use in a trade or business is treated as property similar or related in service or use to the property so converted.[42] This provision allows a disaster victim a great deal of flexibility in qualifying his or her replacement of the destroyed or damaged trade or business property. Essentially, it permits the disaster victim to replace his or her destroyed trade or business property with any type of tangible business property in any trade or business, including an existing business.

E. Distributions from Retirement Plans

In general, the laws relating to profit sharing and stock bonus plans (including Section 401(k) plans) impose various limitations on the permissibility of loans and distributions from those plans. For example, these plans must provide the funds accumulated under the plan may only be distributed upon the occurrence of certain events (e.g. after a fixed number of years, reaching a certain age, severance of employment, etc.). These plans may permit distributions or acceleration of distributions in the case of hardship. However, to make a loan or distribution (including a hardship distribution), a plan must contain language authorizing the loan or distribution. In addition, except to the extent a distribution consists of already-taxed amounts, distributions will be includible in gross income. Furthermore, distributions prior to the employee attaining age 59½ will generally be subject to the ten percent (10%) additional tax under Section

[38] *See* Rev. Rul. 95-22, 1995-1 C.B. 145 (taxpayer recognizes no gain upon the receipt of proceeds for unscheduled contents destroyed in a disaster regardless of the use to which the taxpayer puts those proceeds). residence"

[39] §1033(h)(1)(A)(ii)(I).

[40] §1033(h)(1)(A)(ii)(II).

[41] §1033(h)(1)(B).

[42] §1033(h)(2).

72(t) of the Code. Moreover, plan provisions and regulations require that a plan must establish verification procedures that must be followed before loans or distributions can be made under the plan and must contain procedures designed to confirm that the criteria have been satisfied.

The IRS announced certain tax relief with respect to such profit sharing and stock bonus plans (including Section 401(k) plans) for victims of Hurricane Harvey (the "IRS Plan Relief Announcement").[43] The IRS Plan Relief Announcement stated that distributions from "qualified employer plans" will not be treated as failing to satisfy any requirement under the Code or Treasury Regulations merely because the plan makes a loan or a hardship distribution for the need arising from Hurricane Harvey, to an employee or former employee whose principal residence or place of employment on August 23, 2017 was in one of the federally designated disaster areas for Hurricane Harvey.[44] The IRS Plan Relief Announcement also extended this exception to lineal ascendants or descendants or the spouse of the employee whose those relatives have a principal residence or place of employment is in one of these counties on the applicable date.[45] For purposes of this announcement, a "qualified employer plan" would generally include a profit sharing plan or stock bonus plan (including a Section 401(k) plan).

This relief provides an employer with the ability to expand the types of financial events eligible for a hardship distribution. For example, suppose a profit sharing or stock bonus plan does not include the financial losses of an employee's parent as a hardship. The plan will permit losses to that employee's parent's home to be treated as a hardship under the plan, even though as of August 23, 2017 the applicable plan did not include this damage as qualifying under the plan's definition of hardship.

To make a loan or a hardship distribution pursuant to the relief provided in the IRS Plan Relief Announcement, a qualified employer plan that does not provide for the applicable hardship distribution must be amended to provide for such loans or hardship distributions no later than the end of the first plan year beginning after December 31, 2017. In addition, the hardship distribution must be made on or after August 23, 2017 and no later than January 31, 2018. Under the IRS Plan Relief Announcement, loans must still satisfy the requirements of Section 72(p) of the Code.

Retirement plans will not be treated as failing to follow the procedural requirements for plan loans or distributions imposed by the terms of the plan merely because those requirements are disregarded for any period beginning on or after August 23, 2017 and continuing through January 31, 2018, with respect to loans or other distributions to individuals affected by Hurricane Harvey, provided the plan administrator makes a good-faith diligent effort under the circumstances to comply with those requirements. In addition, as soon as practicable, the plan administrator (or financial institution in the case of IRAs) must make a reasonable attempt to assemble any forgone documentation.

The IRS Announcement did not change the standards otherwise applicable for determining the amount available for hardship. The recently passed Disaster Relief Act of 2017,

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[43] Announcement 2017-11, 2017-39 I.R.B. (Aug. 30, 2017).
[44] *Id.*
[45] *Id.*

however, amended the taxation rules for "qualified hurricane distributions."[46] This Act provided greatly welcomed relief and flexibility for taxpayers needing to take early distributions from their profit sharing and stock bonus plans. Under this Act, the definition of "qualified hurricane distributions" includes any distribution from an eligible retirement made on or after August 23, 2017 and before January 1, 2019, to an individual whose principal place of abode on August 23, 2017, is located in the Hurricane Harvey disaster area and who has sustained an economic loss by reason of Hurricane Harvey.[47]

Under the Disaster Relief Act of 2017:

- qualified hurricane distributions would not be subject to the ten percent (10%) early retirement plan withdrawal penalty;[48]

- taxpayers receiving qualified hurricane distributions can either spread the income inclusion out over a 3 year period beginning with the year that the income would otherwise first be required to be included into income or elect out and include the income all in the year of the distribution;[49]

- taxpayers are permitted to recontribute any qualified hurricane distributions to any eligible retirement plan of which they are a beneficiary at any time over a 3 year period beginning with the date after the distribution was received and receive tax-free rollover treatment;[50]

- qualified hurricane distributions are not subject to the mandatory twenty percent (20%) withholding rule that would normally apply to eligible rollover distributions;[51]

- retirement plan withdrawals for home purchases or construction received after February 28, 2017 and before September 21, 2017 where the home purchase or construction was cancelled due to Hurricane Harvey may be recontributed;[52]

- additional flexibility in structuring loans from retirement plans for qualified hurricane relief was provided by:

  (i) increasing the maximum amount that a participant or beneficiary can borrow from a qualified employer plan under Section 72(b)(2)(A) of the Code increased from $50,000 to $100,000;
  (ii) removing the "one half of present value" limitation; and

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[46] Section 502, Pub. L. 115-63 (September 29, 2017) (Special Disaster-Related Rules for Use of Retirement Funds).
[47] *Id.* at Section 502(a)(4).
[48] *Id.* at Section 502(a)(1).
[49] *Id.* at Section 502(a)(5).
[50] *Id.* at Section 502(a)(3). If at the time of the recontribution a taxpayer paid income taxes on the initial distribution, the taxpayer could file an amended tax return to receive a tax refund on any overpaid income taxes.
[51] *Id.* at Section 502(a)(6)(A).
[52] *Id.* at Section 502(b).

(iii) allowing for a longer repayment term for victims of Hurricane Harvey, if the due date for any repayment for the loan occurs during the period beginning on August 23, 2017 and ending on December 31, 2018, by delaying the due date of the first repayment by one year (and adjusting the due dates of subsequent repayments accordingly).[53]

These provisions should permit taxpayers greater access to their funds being kept in retirement plans without penalizing them for having to withdraw funds early as a result of Hurricane Harvey.

E. Leave-based Donation Programs

In general, if an employee gives their accrued vacation to another employee or the employer (at the request of an employee) pays either that employee or another party an amount in lieu of that accrued vacation, the employee would recognize income on the receipt or deemed receipt of that compensation. On September 5, 2017, the IRS issued Notice 2017-48 indicating that the IRS will not assert that cash payments an employer makes to Section 170(c) organizations in exchange for vacation, sick, or personal leave that its employees elect to forego constitute gross income or wages of the employees if the payments are: (1) made to the Section 170(c) organizations for the relief of victims of Hurricane Harvey and Tropical Storm Harvey and (2) paid to the Section 170(c) organizations before January 1, 2019.[54] The Notice also states that in connection with such payments, the IRS will <u>not</u> assert that the employee is in constructive receipt of such payments or that the employers' deduction of such payments is subject to the limitations of Section 170 of the Code. This Notice makes it easier for employees to donate their accrued but unpaid vacation to charitable organizations providing relief to victims of Hurricane Harvey.

G. Charitable Deduction Limitations

In general, charitable deductions are subject to certain limitations. Individuals who choose to itemize their deductions are subject to limitations of 50%, 30% and 20% of their adjusted gross income on their charitable deductions depending on the type of property contributed and the type of the donee.[55] Corporations are subject to the limitation that the total charitable deductions of each corporation cannot exceed ten percent (10%) of its taxable income.[56] Excess contributions can generally be carried forward up to an additional five years for both individuals and corporations.[57]

The Tax Relief Act of 2017 suspends these limitations for "qualified contributions."[58] Qualified contributions are defined for purposes of Hurricane Harvey as any charitable contribution (within the meaning of Section 170(c) of the Code) that was paid during the period

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[53] *Id.* at Section 502(c).
[54] Notice 2017-48, 2017-39 I.R.B. (Sept. 5, 2017).
[55] §170(b)(1).
[56] §170(b)(2). Excess charitable deductions for a corporation are carried forward up to 15 years.
[57] §170(d).
[58] Section 504(a), Pub. L. 115-63 (September 29, 2017) (Additional Disaster-Related Tax Relief – Temporary Suspension of Limitations on Charitable Contributions).

August 23, 2017 and December 31, 2017 in cash to an organization described in Section 170(b)(1)(A) of the Code and is made for relief efforts in the Hurricane Harvey disaster area. Accordingly, taxpayers making donations to charities (within the meaning of Section 170(b)(1)(A) of the Code) should generally be able to take a deduction for those donations regardless of the normal limitations.

H. Employee Retention Tax Credit for Disaster Zone Employers

The Tax Relief Act of 2017 added an employee retention income tax credit for employers affected by Hurricane Harvey.[59] This is a general business tax credit under Section 38 of the Code. Under the Act, an eligible employer will receive a federal income tax credit equal to forty percent (40%) of up to $6,000 of the qualified wages with respect to each eligible employee of such employer for the tax year (i.e. a maximum tax credit of $2,400 per employee).[60] An eligible employer qualified employer is defined as any employer which conducted an active trade or business on August 23, 2017 in the Hurricane Harvey disaster zone and such business was inoperable on any day after August 23, 2017 and before January 1, 2018 as a result of damage sustained by reason of Hurricane Harvey.[61] An eligible employee means, with respect to an eligible employer, an employee whose principal place of employment on August 23, 2017 with such eligible employer was in the Hurricane Harvey disaster zone.[62] Qualified wages are defined as wages paid or incurred by an eligible employer with respect to an eligible employee on any day after August 23, 2017 and before January 1, 2018 which occurs during the period beginning on the date on which the applicable trade or business first becomes inoperable at the principal place of employment where the eligible employee worked immediately before August 23, 2017 and ending on the date on which such trade or business has resumed significant operations at such principal place of employment.[63] Effectively, this provision provides employers some tax relief where the employers continue to pay employees during the down-time caused resulting from Hurricane Harvey in order to retain those employees.

I. Earned Income for Purposes of the Earned Income Tax Credit and Childcare Tax Credit

In general, eligible individuals may qualify for an earned income tax credit under Section 32 of the Code and a childcare tax credit under Section 24 of the Code. The calculation of the amount of each of these tax credits is based in part on the amount of the individual's earned income. Under the Tax Relief Act of 2017, "qualified individuals" are permitted to use their 2016 earned income for purposes of calculating the earned income tax credit and childcare tax credit for 2017.[64] A "qualified individual" is defined as one whose principal place of abode on August 23, 2017 was: (i) located in either the Hurricane Harvey disaster zone or the Hurricane Harvey disaster area and (ii) the individual was displaced from their principal place of abode by

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[59] Section 503(a), Pub. L. 115-63 (September 29, 2017) (Disaster-Related Employment Relief - Employee Retention Credit for Employers Affected by Hurricane Harvey).

[60] *Id.* at Section 503(a)(1).

[61] *Id.* at Section 503(a)(2)(A).

[62] *Id.* at Section 503(a)(2)(B).

[63] *Id.* at Section 503(a)(2)(C).

[64] Section 505(c), Pub. L. 115-63 (September 29, 2017) (Additional Disaster-Related Employment Tax Relief Provisions – Special Rule for Determining Earned Income).

reason of Hurricane Harvey. [65] These provisions permit taxpayers that are eligible for the earned income tax credit and the childcare tax credit to not see these credits reduced as a result of being displaced by Hurricane Harvey.

J. Section 179 Expensing and Additional First Year Depreciation

In general, Section 179 of the Code permits businesses to expense up to $500,000 of their purchases for any taxable year for tangible property and certain computer software that is Section 1245 property and used in an active trade or business. The $500,000 limit is reduced (not below zero) on a dollar for dollar basis to the extent by which the cost of similar property placed in service for that taxable year exceeds $2,000,000.[66] For qualified § 179 disaster assistance property, (i) the $500,000 limit is increase by the lesser of $100,000 or the cost of qualified § 179 disaster assistance property and (ii) the $2,000,000 amount is increased by the lesser of $600,000 or the cost of qualified § 179 disaster assistance property placed in service during the tax year.[67] Qualified § 179 disaster assistance property is property that meets the seven requirements of Section 168(n)(2) of the Code. Among the requirements is that the property must rehabilitate property damaged by or replace property destroyed or condemned as a result of a federally declared disaster and is similar in nature to, and located in the same county as, the property being rehabilitated or replaced.[68] Under Section 168(n) of the Code, the fifty percent (50%) additional bonus depreciation is also available for qualified disaster assistance property.[69]

These provisions should help encourage businesses that were hurt by Hurricane Harvey to rebuild in the same areas that were damaged.

ADDITIONAL TAX RELIEF

In addition to the tax relief currently available, Congress could subsequently determine that additional tax relief is needed to help disaster victims rebuild their lives and businesses. This additional relief could come in the form of traditional incentives such as tax credits or tax exempt financing or through other new incentives.

Although it is beyond the scope of this article to speculate on what additional tax relief could and should be made available, it is at least a positive sign that Congress was able to put aside their differences to pass the Disaster Relief Act of 2017. The tax relief that was made available through those actions and through the mechanism's already in place, should be a great first step in providing needed tax relief to the taxpayers and businesses battered by Hurricane Harvey.

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[65] *Id.* at Section 505(c)(2).
[66] §179(b).
[67] §179(e)(1).
[68] §168(n)(2)(A)(iii)..
[69] §168(n).

THE IRS APPEALS PROCESS:
A PRIMER IN RESOLVING FEDERAL TAX DISPUTES WITHOUT LITIGATION

by Mary A. McNulty and Lee Meyercord*

When faced with a Revenue Agent's Report ("RAR"), a taxpayer may file a protest within 30 days and cause the case to be sent to the IRS Office of Appeals for resolution. Part I of this Article summarizes the Appeals process. Part II summarizes the taxpayer's options regarding any issues that are not settled in Appeals.

I. SUMMARY OF APPEALS PROCESS

A. APPEALS MISSION AND OVERVIEW

The Appeals Office is an informal administrative forum for taxpayers who disagree with an auditor's determinations in the RAR. The objective of the Appeals Office is to resolve tax controversies, *without litigation*, on a basis that is fair and impartial to both the Government and the taxpayer.[1] This impartiality is ensured in part because the Appeals Office is independent and separate from the IRS Exam team who conducted the audit.[2] To maintain this independence and impartiality, the Appeals Officers cannot discuss substantive issues in the case with the Exam team without the taxpayer's participation.[3]

The Appeals Office is highly successful: in tens of thousands of cases each year, the Appeals Officers negotiate and settle between 85 to 90% of these cases.[4] This high settlement rate results in part from how an Appeals Officer's success is evaluated – by their success in compromising with taxpayers, not by how much they uphold the IRS auditor's findings.[5]

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[1] I.R.M. 8.1.1.1(1) (10/23/2007); Treas. Reg. § 601.106(f)(1).

[2] The independence of the Appeals Office is mandated by Congress. IRS Restructuring and Reform Act of 1998, HR 2676, 105th Cong. 2d Sess. § 1001(a)(4) (1998).

[3] Rev. Proc. 2012-18, 2012-10 I.R.B. 455. Examples of *ex parte* communications that are prohibited include discussions about the accuracy of facts presented by the taxpayer, the relative merits of authorities cited in the taxpayer's protest, the Exam team's perception of the demeanor or credibility of the taxpayer or the taxpayer's representative, and the Exam team's view of the strengths and weaknesses of the parties' positions in the case.

[4] I.R.M. 8.1.1.1 (10/01/2016); *see* INTERNAL REVENUE SERV., ANNUAL REPORT FOR 1988 36 (1998) (stating "Appeals officers, located in major cities, met with taxpayers and their representatives and were usually successful in resolving disputed issues. Appeals closed approximately 93,000 cases, of which 90 percent were agreed"). Current publications suggest the Appeals office closes over 100,000 cases annually. GOV. ACCOUNTABILITY OFFICE, TAX ADMINISTRATION: OPPORTUNITIES TO IMPROVE COMPLIANCE DECISIONS AND SERVICE TO TAXPAYERS THROUGH ENHANCEMENTS TO APPEALS' FEEDBACK PROJECT 1 (2006) [hereinafter GAO Appeals Report].

Appeals Officers are instructed to attempt to reach an agreement with the taxpayer on all issues susceptible to resolution.[6] Not only are the overwhelming majority of cases settled, but over 70% of the cases are settled in a manner that is satisfactory to the taxpayer. In addition, according to the IRS's own statistics, the Appeals process historically results in a tax liability that is 40% lower than the initial proposed liability.[7]

There are two steps to the Appeals process. First, the taxpayer files a formal protest with the Appeals Office. Second, after receiving the formal protest and reviewing all the relevant documents, the Appeals Officer holds an Appeals conference. Each step is addressed in more detail below.

B. FORMAL PROTEST LETTER

The first step in the Appeals process is to file a formal written protest letter within 30 days of receiving the RAR.[8] A "protest" is the term for officially appealing an IRS determination. A written protest is required in all cases in which the total amount of proposed additional tax exceeds $10,000.[9] The filing of the protest gives the Appeals Office jurisdiction over the case.[10]

The protest is the taxpayer's opportunity to explain its view on each protested issue. Although there is no specific form, the protest must contain the following items: the taxpayer's name and address, the date and symbols from the RAR regarding the proposed adjustments, the tax periods or years involved, a statement of the adjustment being protested, a statement of the facts supporting the taxpayer's position on any factual issue, and a statement outlining the law or other authority on which the protest relies.

If the taxpayer raises new information or new issues that the Exam team did not consider, the Appeals Officer will generally send the case back to the Exam team to consider the new information or new issues and make a determination.[11] New information is any information

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[5] The emphasis on settling cases is demonstrated in Revenue Procedure 79-34, which notes that the Appeals Process is characterized by the satisfactory number of agreed settlements. Rev. Proc. 79-34, 1979-2 C.B. 498.
[6] I.R.M. 8.6.4.1.7 (10/26/2007).

[7] This percentage may be dated. While this number is currently cited with some frequency, the only statistical data from the IRS was published in 1991. FREDERICK DAILY, STAND UP TO THE IRS 114 (1st ed. 1992).

[8] Treas. Reg. §§ 601.105(d)(2), 601.106(a)(1)(iii).

[9] Treas. Reg. § 601.106(a)(1)(iii)(c).

[10] In a pre-statutory notice of deficiency case, the Appeals Office acquires jurisdiction when the taxpayer requests Appeals Office consideration and files a protest of the determination of tax liability. Treas. Reg. § 601.106(b).

[11] I.R.M. 8.2.1.7.2(1) (08/11/2015). If there will be less than 210 days remaining on the statute of limitations after the case is returned to Exam, the Appeals Officer will solicit a consent to extend the statute of limitations. I.R.M. 8.6.1.6.4(2) (06/25/2015); I.R.M. 8.6.1.6.5(3) (10/01/2016). These rules were implemented as part of the Appeals Judicial Approach and Culture program ("AJAC"), which focused on reinforcing Appeals' quasi-judicial approach to cases and reducing the amount of case development done at Appeals.

related to a disputed issue that the taxpayer did not previously share with Exam and that the Appeals Officer determines merits additional analysis or investigative action by Exam.[12] After Exam has had the opportunity to examine any new issues the taxpayer raised in Appeals, the Appeals Officer will consider the issue.[13] Unlike new information or new issues that the taxpayer raises in Appeals, if the taxpayer raises a new legal theory or argument that requires further development, the Appeals Officer will retain jurisdiction of the case but share the information with the Exam team for review and comment.[14]

The Appeals Officer will not raise new issues or reopen a previously agreed issue and will focus instead on resolving the disagreements identified by the taxpayer and Exam.[15] The Appeals Officer may consider new authority that supports an argument previously presented as this is not a new issue.[16] The Appeals Officer also may consider new theories or alternative legal arguments that support the parties' positions when evaluating the hazards of litigation.[17]

After the protest is filed, the Exam team will review the protest and submit a rebuttal to Appeals. The purpose of the rebuttal is not to restate the positions taken in the RAR, but rather, to respond to new information or issues raised in the protest.[18] The Appeals Officer will receive the protest, rebuttal, examiner's report, examiner's work papers, correspondence, and other relevant papers. For each issue in dispute, the Appeals Officer may request additional documents or information.[19]

C. APPEALS CONFERENCE

Once the Appeals Officer has received all of the relevant documents from the Exam team, the Appeals Officer will schedule an Appeals conference. This conference will be set at a date reasonably convenient to the taxpayer and their representatives.[20] Historically, a taxpayer

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[12] I.R.M. 8.6.1.6.5(1) (10/01/2016). Additional analysis includes "[c]ategorizing, sorting, or reviewing large volumes of records, or requiring additional steps or reasoning to reach a conclusion." *Id*. Investigative action means "actions required for fact finding, to make inquiries or to verify the authenticity of an item."

[13] I.R.M. 8.6.1.6.4(1) (06/25/2015).

[14] I.R.M. 8.2.1.7.2(4) (08/11/2015).

[15] I.R.M. 8.6.1.6.2(1) (10/01/2016); I.R.M. 8.6.1.6.1(1) (10/01/2016). Treas. Reg. § 601.106(d)(1) has not been updated to reflect AJAC and allows the Appeals Officer to reopen an agreed issue or raise a new issue if the grounds for the action are "substantial" and the potential effect on tax liability is "material."

[16] I.R.M. 8.6.1.6.2(4) (10/01/2016).

[17] I.R.M. 8.6.1.6.2(3) (10/01/2016).

[18] I.R.M. 4.46.5.7.3(3) (03/09/2016).

[19] Information provided in response to a question from the Appeals Officer to clarify or corroborate information referenced in the examination report, protest or rebuttal, will usually not be provided to Exam for review and comment. I.R.M. 8.6.1.6.5(1) (10/01/2016).

[20] I.R.M. 8.6.1.3.1(1) (11/06/2007).

would be able to have an in-person Appeals conference, if requested. IRS guidelines revised in 2016, however, provide that while either the taxpayer or the Appeals Officer may request an in-person conference, the Appeals Team Manager will decide whether to grant the request and the decision is based on the facts and circumstances of the case, including whether:[21]

- There are substantial books and records to review that cannot be easily referenced with page numbers or indices;
- The Appeals Officer can judge the credibility of the taxpayer's oral testimony without an in-person conference;
- The taxpayer has special needs (e.g. disability, hearing impairment) that can only be accommodated with an in-person conference;
- There are numerous conference participants (e.g., witnesses) that create a risk of an unauthorized disclosure or breach of confidentiality;
- An alternative conference procedure (e.g., Post Appeals Mediation (PAM) or Rapid Appeals Process (RAP)) involving separate caucuses will be used; and
- Other IRS guidelines call for an in-person conference.[22]

In response to criticism for this change, on September 15, 2017, the IRS announced that it will allow taxpayers to have in-person Appeals conferences in field cases, but in-person conferences will continue to be the exception for campus cases.[23]

The Appeals conference typically takes place about three months after the IRS rebuttal is submitted. In complex cases covering multiple issues over a number of years, multiple conferences may be held to fully discuss all the issues. These conferences are informal and are a frank discussion between the Appeals Officer and the taxpayer about the issues. The Appeals Officer first meets with the Exam team. Due to the prohibition on ex parte communications, the Appeals Officer invites the taxpayer to be present at that conference. The taxpayer is a silent participant at the conference with the Exam team, unless the Appeals Officer specifically asks the taxpayer to respond.

1. <u>Presentation of Taxpayer's Arguments</u>

The Appeals conference provides the taxpayer with the opportunity to present its position to the Appeals Officer. This presentation includes responding to the Exam team's arguments and answering the Appeals Officer's questions. The rules of evidence that apply in courts do not apply in the Appeals hearing, so the taxpayer (or its representative) can submit evidence to the Appeals Officer that may not be admissible in a court of law. There is no sworn testimony, although the Appeals Officer may require factual matters to be submitted in the form of an

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[21] I.R.M. 8.6.1.4.1(1), (4); *see also* I.R.M. 8.1.1.1(3) (10/01/2016) (stating the Appeals conferences "are usually held by telephone or correspondence.").

[22] I.R.M. 8.6.1.4.1(1), (4).

[23] Stephanie Cumings, "IRS Appeals Moving Back to In-Person Conferences," 156 TAX NOTES TODAY 1686 (Sept. 25, 2017).

affidavit or declared to be true under penalty of perjury.[24] Taxpayers also can bring experts to the Appeals conference to assist with technical factual points.

In October 2016, the Internal Revenue Manual was revised to emphasize that the Appeals Officer has discretion to invite the Exam team or IRS Counsel to the conference.[25] About one-third of the Appeals team case leaders volunteered for a pilot program to include the Exam team in the conference.[26] Under the pilot program, the Exam team is present during the presentation of the taxpayer's arguments, but excluded from any settlement negotiations.[27]

An Appeals Officer is permitted to request technical advice from the National Office on any technical or procedural questions that develop during consideration of the case.[28] Similarly, a taxpayer may request technical advice from the National Office while at Appeals, but only on the grounds that a lack of uniformity exists as to the disposition of the issue or that the issue is so unusual or complex as to warrant consideration by the National Office.[29] This technical advice is issued in the form of a Technical Advice Memorandum, in which the National Office advises as to how tax law, treaties, regulations, revenue rulings or other IRS publications apply in a particular situation. If the technical advice is favorable to the taxpayer, the Appeals Officer is bound by the technical advice.[30] If the technical advice is unfavorable to the taxpayer, then the Appeals Officer is not bound by the advice, and the Officer may settle the issue under existing authority without regard to the technical advice.[31] Both Appeals Officers and taxpayers are seeking less technical advice in recent years, due primarily to the inclusion of a technical adviser on the Appeals team.

2. Negotiating a Settlement

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[24] Treas. Reg. § 601.106(c).

[25] I.R.M. 8.6.1.4.4; *see also* Treas. Reg. § 601.106(c) ("At any conference granted by Appeals on a nondocketed case, the district director will be represented if the Appeals official having settlement authority and the district director deem it advisable.").

[26] Andrew Velarde, "IRS Appeals Continues to Defend Exam's Presence in Conferences," 156 TAX NOTES TODAY 1644 (Sept. 25, 2017); Matthew R. Madara, "IRS Addressing Concerns Over Appeals Conference Pilot Program" 155 TAX NOTES TODAY 1669 (Jun. 19, 2017).

[27] Matthew R. Madara, "IRS Addressing Concerns Over Appeals Conference Pilot Program" 155 TAX NOTES TODAY 1669 (Jun. 19, 2017) (At the Texas Federal Tax Institute, IRS Appeals Deputy Chief Nikole Flax stated that Exam should not be involved in the Appeals conference once the facts are established, the differences in legal theory are known, and settlement negotiations are beginning.)

[28] Treas. Reg. § 601.106(f)(9)(ii)(a); Rev. Proc. 2005-2, 2005-1 C.B. 86.

[29] Treas. Reg. § 601.106(f)(9)(iii)(a).

[30] Treas. Reg. § 601.106(f)(9)(viii)(c).

[31] *Id*.

After the taxpayer has presented its position, the Appeals Officer will discuss settlement with the taxpayer. A settlement can resolve each issue on the basis of the probable results in litigation or involve mutual concessions of issues based upon the relative strengths of the opposing positions when there is substantial uncertainty as to the outcome in litigation.[32] The Appeals Officer will consider the "hazards-of-litigation" in determining an appropriate settlement. Under this hazards-of-litigation standard, the Appeals Officer will determine what a court might decide on the basis of provable facts, the effect of the testimony likely to be presented, and the expected interpretation and application by the court of the Internal Revenue Code provisions and applicable regulations in the light of decided cases. The Appeals Officer is not allowed, however, to settle a case for nuisance value -- i.e., to avoid the expense of going to court.[33] There is no clear line that divides nuisance value from good faith offers, but a concession of 10% or less appears to be the guideline frequently used.[34] In the end, the Appeals Officer either reaches a basis of settlement with the taxpayer or determines that there is no mutually acceptable basis for settlement. A settlement can be reached on some or all of the issues.

3. Post-Appeals Conference Mediation

If the taxpayer does not settle some issues during the Appeals conference, the taxpayer may request post-appeals mediation for factual or legal issues.[35] Mediation is a nonbinding process in which a mediator, a neutral third party, tries to help the Appeals Officer and the taxpayer reach their own negotiated settlement.[36] Mediation is at the taxpayer's election, and the procedure is conducted through the Appeals Office. Part II below sets forth the taxpayer's options if no settlement is reached in Appeals.

4. Documenting the Settlement

Appeals Officers do not have final authority to settle tax cases. Therefore, any settlement reached with an Appeals Officer is not binding until it is approved by a reviewing Officer in the Appeals Office. If the Appeals Officer recommends acceptance of the taxpayer's proposed settlement and the reviewing Officer disapproves (which is rare), then the taxpayer may have a conference with the reviewing Officer.[37]

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32 *See, e.g.*, I.R.M. 8.6.4.1.1 (10/26/2007) (addressing mutual-concession settlements); I.R.M. 8.6.4.1.2 (10/26/2007) (discussing split-issue settlements).

33 Treas. Reg. § 601.106(f)(2); I.R.M. 8.6.4.1.3 (10/26/2007).

34 Saltzman & Saltzman, ¶ Appeals Settlement Practice and Procedures, IRS Practice and Procedure.

35 I.R.C. § 7123(b). The IRS implemented an arbitration program in 2000, but eliminated the program in 2015 after finding it was unsuccessful at resolving disputes without litigation (during the 14-year program only 2 cases were settled using arbitration) and the lack of demand. Rev. Proc. 2015-44, 2015-38 I.R.B. 354.

36 Rev. Proc. 2014-63, 2014-53 I.R.B. 1014.

37 Treas. Reg. § 601.106(f)(3).

Once a settlement is reached with the Appeals Officer and approved by the reviewing Officer, the settlement will be documented by either a Form 870, Form 870-AD, or a Closing Agreement.[38] All three forms waive the restrictions on the assessment and collection of any deficiency that results from the settlement.[39] The forms differ in their level of finality. The Form 870 is solely a waiver of restrictions on assessment and does not prevent a taxpayer from subsequently filing a claim for refund in district court or the Court of Federal Claims or the IRS from subsequently making additional assessments of tax.

In contrast, the Form 870-AD includes language precluding both the taxpayer and the IRS from reopening the case. A case closed by Appeals on the basis of concessions by both parties with a Form 870-AD will not be reopened by the IRS in the absence of fraud, malfeasance, concealment or misrepresentation. The Form 870-AD is the most commonly used form in settling an appeal.

The third option, a Closing Agreement, is used in limited circumstances. A Closing Agreement is used when the agreement involves concessions of continuing issues that affect later years or related cases. A Closing Agreement bars the filing of a refund claim under contract principles and can only be rescinded following the showing of fraud, malfeasance or misrepresentation of material fact.[40] A Closing Agreement is final and must be signed by someone with the delegated authority to enter into a Closing Agreement.[41]

Regardless of the form used to document the settlement, the IRS will not sign the form until Joint Committee has completed its review.[42] All cases involving a refund or credit in excess of $2 million (or $5 million in the case of a C corporation) must be submitted to Joint Committee for review.[43] In determining whether the jurisdictional amount is met, any refund of previously paid penalties or interest is included in the jurisdictional amount, and the credit or refund is offset by any agreed deficiency for that year.[44] Joint Committee review may also be

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[38] I.R.C. § 7121.

[39] Treas. Reg. § 601.106(d)(2).

[40] I.R.C. § 7121(b).

[41] I.R.M. 1.2.47.4 – Delegation Order 8-3 (15) (08/18/1997) (providing the following have the authority to enter into closing agreements in Appeals cases in their jurisdiction: regional directors of appeals; assistant regional directors of appeals; chiefs and associate chiefs of appeals offices; and appeals team chiefs with respect to their team cases); Treas. Reg. § 301.7121-1(a).

[42] I.R.M. 8.7.9.5.6(1) (09/27/2013); *see also* I.R.M. 8.7.9.5.1(2) (09/27/2013) (providing "no settlement should be made effective until receipt of notice that the JCT has no objection to the proposed overpayment.").

[43] I.R.C. § 6405(a).

[44] I.R.M. 8.7.9.6.3(3) (09/27/2013).

necessary if the closing agreement will impact a case that is or will be reported to Joint Committee.[45]

If Joint Committee review is required, Appeals will submit a report summarizing the facts and decision of Appeals. The report will be reviewed by an experienced Joint Committee staff member. In straight-forward cases the refund can be approved in about a month, but more complicated cases tend to take longer.[46] Generally, the majority of cases are approved by Joint Committee without issue; however, in the event Appeals and Joint Committee cannot agree, a conference can be held. [47]

II. ISSUES NOT RESOLVED IN APPEALS PROCESS

If the taxpayer is unable to reach a settlement with Appeals, the IRS will issue a notice of deficiency. This notice describes the tax deficiency and states that the taxpayer has 90 days to file a petition with the Tax Court for a redetermination of the deficiency. Because of Appeals' high success rate in carrying out its mission to resolve federal tax controversies without litigation, tax litigation is becoming increasingly rare. Administrative resolutions are less expensive and time-consuming for taxpayers and therefore often the preferred route for taxpayers.

When faced with a 90-day letter, the taxpayer has three options: (1) petition the U.S. Tax Court for a redetermination of the deficiency; (2) permit the 90-day period to lapse and pay the assessed tax, file a claim for refund with the IRS, and then institute a refund suit in federal district court or the U.S. Court of Federal Claims; or (3) permit immediate assessment of the deficiency and pay the additional tax.[48] A taxpayer may make a "qualified offer" to settle the case. If the IRS rejects the qualified offer and the issue is ultimately settled in court for an amount equal to or less than a qualified offer, the taxpayer is treated as the prevailing party and may recover administrative and litigation fees and costs.[49]

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[45] I.R.M. 8.7.9.5.6(3) (09/27/2013). In this situation, advance review of the closing agreement can be requested in an informal procedure.

[46] Donald C. Alexander & Brian S. Gleicher, *IRS Procedures: Examinations and Appeals*, 623 TAX MNGT. PORT. (BNA) A-115 (2010).

[47] *Id*. (estimating almost 90% of cases are approved without question, and even in the rare circumstance Joint Committee questions the refund, Joint Committee and IRS ultimately agree over 90% of the time).

[48] Treas. Reg. § 601.103(c).

[49] I.R.C. § 7430(c), (g).

How Does Texas Law Compare to the Revised Uniform Unclaimed Property Law?

State Bar of Texas

State and Local Tax Committee

Annual Briefing

September 21, 2017

PRESENTER

Charolette Noel, Jones Day*

*The views in this summary are the personal views of the presenter and do not necessarily represent the view of Jones Day, its clients, or other organizations with which the presenter is affiliated.

Revised Uniform Unclaimed Property Act (RUUPA)

- **Background on Uniform Law Commission Acts**
  - First adopted in 1954, revised in 1966, substantially amended as UUPA in 1981, updated (collection focus) in 1995, recently revised in 2016 (the "RUUPA")
  - So far 4 states have enacted RUUPA: **DE, IL, TN & UT**
  - Only 16 states* adopted the 1995 Act
  - 29 states * adopted 1981 Act originally; now 24 states* have substantially enacted the 1981 Act
  - 1954/66 Act enacted by 7 states*, Ex: **CA, CT, IL, NE, PA**
  - 6 states* have unique custodial laws, Ex: **MA, NY OH, TX**

*States include US Territories: DC, GU, PR and VI

Revised Uniform Unclaimed Property Act (RUUPA)

- **ULC Drafting Committee Process**
  - ABA advisors and NAUPA advisors appointed to Drafting Committee, often viewed as opponents
  - Extraordinary Efforts and Responses
    - Drafting over 3 years, meetings with > 100 observers
    - 150+ stakeholders submitted > 100 sets of comments, available online at http://www.uniformlaws.org/Narrative.aspx?title=ULC%20Drafting%20Process
    - 1981 Act used as basis for revisions

Revised Uniform Unclaimed Property Act (RUUPA)

- **Key Substantive Constitutional Concerns:**
  - Exceptions to substantive law, recharacterizing contracts and expanding states’ derivative rights
  - Short dormancy/liquidation of stock and tax-deferred accounts without due notice or making whole (improvement)
  - Escheat of known foreign-owned property;
  - Duplicate jurisdiction for escheat and asserting regulation without due process jurisdiction;
  - Claims to nonexistent property via reversing burden of proof (improvement) or estimating existence of property

Revised Uniform Unclaimed Property Act (RUUPA)

- **Examples of Procedural Concerns**
  - Statute of limitations on reporting beyond required record retention (improvement)
  - No statute of repose (addressed!)
  - Record retention beyond reasonable
  - Statute of limitations on <u>owner's</u> right to claim;
  - Limits on indemnification for "good faith" reporting (improvement)
  - Procedures for conducting examinations, maintaining confidential data, and fair appeals (improvement)

Revised Uniform Unclaimed Property Act (RUUPA)

- **Examples of Policy Concerns**
  - Overburden of business cost -- monitoring, reporting, defending audits of B2B transactions; no business cost-savings by reciprocal reporting
  - Insufficient efforts to reunite property to owner
  - Failure to address ERISA and other preemption and conflicts with underlying substantive law
  - Eliminating perception of conflict of interest of contingent fee auditors
  - Excessive interest and penalty for costly and challenging compliance

RUUPA – Comparing Factors for COST Scorecard Grade = C

Issue	Minority Position	Minority Supported by:	Option to Adopt Minority Position?
Gift Cards	Not Exempt	NAUPA	Yes
Business-to-business	Exempt	Business	No
Contingent-Fee Auditors	Banned	Business	No

Texas Law:

- Gift Cards are exempt IF no expiration and only permitted fees under § 35.42(d).
- No statutory B2B exemption - BUT credit balances to current customers should not be reported AND per § 72.101(a), property is only presumed abandoned if "the existence and location of the owner of the property is unknown to the holder of the property."
- Contract for-profit auditors are used regularly.

Links to Helpful Resources

- RUUPA Final Act 2016:
  http://www.uniformlaws.org/shared/docs/Unclaimed%20Property/RUUPA_Final%20Act_2016.pdf

- RUUPA Legislative Tracking and Enactment Map:
  http://www.uniformlaws.org/Act.aspx?title=Revised%20Uniform%20Unclaimed%20Property%20Act

- Texas Unclaimed Property Statutes (Title 6 – Property Code)
- Texas Unclaimed Property Reporting Instructions
  - Both available under "Guides" at:
  https://comptroller.texas.gov/programs/claim-it/report/forms/index.php

- Texas Audit Procedures for Unclaimed Property (August 2017):
  https://comptroller.texas.gov/taxes/audit/docs/up-manual.pdf

State Bar of Texas
State and Local Tax Committee
Annual Comptroller Briefing
Austin, TX

September 21, 2017

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Agenda

1 Factor Presence Nexus

Nexus Generally

Constitutional Limitations on State Taxation

- **Nexus**: Nexus is a sufficient connection between a state and a taxpayer which allows the state to impose its taxing jurisdiction on that taxpayer.
  - Due Process Clause
  - Commerce Clause
- A state is not permitted to tax an entity unless the entity has a "substantial nexus" with the taxing state.
- The substantial nexus standard for sales and use tax purposes requires some type of physical presence in the taxing state. *See Quill Corp. v. N. Dakota*, 504 U.S. 298 (1992).
  - There is an ongoing debate as to whether physical presence is required for other tax types (e.g., net income, gross receipts, etc.).

Nexus

Factor Presence Nexus (Gross/Net Income Tax)

- States are increasingly asserting that an out-of-state taxpayer's economic presence in a state is enough to establish substantial nexus, even if the taxpayer lacks a physical presence in the state, and some state courts have agreed.
  - *See, e.g.*, *Crutchfield, Inc. v. Testa* (Ohio); *Capital One Auto Fin., Inc. v. Dep't of Revenue* (Oregon); *Geoffrey, Inc*. *v. S.C. Tax Comm'n* (South Carolina).
- Factor Presence Nexus
  - Many states have adopted factor presence nexus statutes, which base nexus determinations exclusively on a set of quantitative criteria.
- MTC Model Statute
  - $50,000 property; or
  - $50,000 payroll; or
  - $500,000 sales; or
  - 25% of total property, total payroll, or total sales.

Nexus
Factor Presence Nexus (Gross/Net Income Tax)

State	Thresholds
Alabama	\$500,000 (sales) / \$50,000 (property) / \$50,000 (payroll) / 25% total property, payroll, or sales.
California	\$500,000 (sales) / \$50,000 (property) / \$50,000 (payroll) / 25% total property, payroll, or sales. Thresholds are indexed annually.
Colorado	\$500,000 (sales) / \$50,000 (property) / \$50,000 (payroll) / 25% total property, payroll, or sales.
Connecticut	\$500,000 receipts.
New York	\$1,000,000 receipts.
Ohio	\$500,000 (sales) / \$50,000 (property) / \$50,000 (payroll) / 25% total property, payroll, or sales.
Tennessee	\$500,000 or 25% sales / \$50,000 or 25% property / \$50,000 or 25% payroll
Washington	\$250,000 (sales) / \$50,000 (property) / \$50,000 (payroll) / 25% total property, payroll, or sales. Thresholds are indexed annually.

Nexus
Factor Presence Nexus (Sales & Use Tax)

- States are aggressively challenging or undermining the *Quill Corp. v. North Dakota* physical presence standard, through both legislative and administrative action.
  - Factor Presence Nexus
    - Litigation in Alabama, South Dakota, and Tennessee.
    - South Dakota litigation could reach U.S. Supreme Court as early as this year.
    - State action appears to be a direct response to Justice Kennedy's concurring opinion in *Direct Marketing Association v. Brohl*, Dkt. 13-1032 (U.S. 2015).
  - Sales & Use Tax Obligations for Marketplace Operators
    - Minnesota, Rhode Island, Washington, Pennsylvania (proposed)
  - Physical Presence via In-State Software and/or Cookies
    - e.g., Massachusetts, Ohio, Texas.
- Use Tax Notice and Reporting Measures for Remote Retailers.
  - Constitutionality upheld in *Direct Marketing Association v. Brohl*, Dkt. 12-1175 (10th Cir. 2016) (cert. denied).

Nexus
Factor Presence Nexus (Sales & Use Tax)

State	Thresholds	Effective Date
Alabama*	$250,000/yr.	Jan. 1, 2016.
Massachusetts	$500,000/yr and 100+ separate Massachusetts sales.	Oct. 1, 2017 (if promulgated). Hearing will be held on August 24, 2017.
Minnesota	$10,000 through an in-state “marketplace provider.”	Earlier of (1) *Quill* overruled, (2) July 1, 2019, or (3) congressional action.
North Dakota	$100,000/yr or 200+ separate North Dakota sales.	*Quill* overruled.
Ohio	$500,000/yr and use of in-state software.	January 1, 2018.
Rhode Island**	$100,000 or 200+ separate transactions.	August 3, 2017.
South Dakota*	$100,000/yr or 200+ separate South Dakota sales.	May 1, 2016.
Tennessee*	$500,000/yr.	March 1, 2017 (register); July 1, 2017 (collect).
Vermont	$100,000/yr or 200+ Separate Vermont sales.	Later of July 1, 2017 or *Quill* overruled.
Washington**	$10,000/yr.	Jan. 1, 2018.
Wyoming	$100,000/yr or 200+ separate Wyoming sales.	July 1, 2017.

* Enforcement currently suspended.

** Election to register or comply with notice and reporting requirements.

Use Tax Notice and Reporting Measures

State	Thresholds	Effective Date
Alabama	None Stated/TBD. Authority granted to require use tax notice and reporting measures, but not yet implemented.	None Stated/TBD.
Colorado	$100,000/yr.	July 1, 2017.
Kentucky	$100,000/yr (notice only).	July 1, 2013.
Louisiana	$50,000/yr.	July 1, 2017.
Oklahoma	$100,000/yr (notice only).	Oct. 1, 2010.
Rhode Island*	$100,000 or 200+ separate transactions.	Aug. 17, 2017.
South Dakota	$100,000/yr. (notice only).	July 1, 2011.
Vermont	• Notice at point of sale – ALL noncollecting vendors. • Annual customer purchase summary – $500+ in Vt. purchases • Department filing – $100,000/yr.	July 1, 2017.
Washington*	$10,000/yr.	Jan. 1, 2018.

* Election to register or comply with notice and reporting requirements

Sales & Use Tax Obligations for Marketplace Operators

State	Thresholds	Effective Date
Minnesota	$10,000/yr.	Earlier of (1) *Quill* overruled, (2) July 1, 2019, or (3) congressional action.
Rhode Island*	$100,000 or 200+ separate transactions.	Aug. 3, 2017.
Washington*	$10,000/yr.	Jan. 1, 2018
Pennsylvania**	None stated	N/A (pending legislation)

* Election to register or comply with notice and reporting requirements
** Passed Senate; next scheduled PA House session is September 11, 2017

2 Alternative Apportionment

Alternative Apportionment
UDITPA Section 18

If the allocation and apportionment provisions . . . do not fairly represent the extent of the taxpayer's business activity in this State, the taxpayer may petition for or the tax administrator may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

a) separate accounting;

b) the exclusion of any one or more of the factors;

c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or

d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Alternative Apportionment
Application

- Alternative apportionment was originally intended by drafters of UDITPA to apply only in unusual circumstances.
  - Strong presumption in favor of statutory apportionment.
- However, states have increasingly applied alternative apportionment methods where the statutory apportionment rules result in less income apportioned to the state than the state believes is fair.
- Importance in context of single sales factor apportionment/market-based sourcing.

Alternative Apportionment
Application

- The party invoking alternative apportionment generally carries the burden of proof in showing:
  - Distortion exists; and
  - That a proposed alternative method is reasonable.
- Burden of proof (e.g., "clear and convincing," "preponderance," etc.) varies by jurisdiction.
- State rules vary with regard to the procedure for requesting alternative apportionment.
- Is the playing field level?
  - Taxpayer must request advance permission from tax collector.
  - Tax collector imposes alternative apportionment.

Alternative Apportionment
Relevant Cases

- *Matter of Philip Morris USA Inc.*, California FTB Section 25137 Petition
  - PM USA manufactured tobacco products for sale in several states, including California. The manufacturing operations were located entirely in Virginia. PM USA also managed the Philip Morris brands.
  - PM USA argued that California's single sales factor apportionment formula was "qualitatively and quantitatively distortive" when applied to PM USA because, in contrast to other consumer products companies, PM USA operates in a highly regulated industry which imposes restrictions on its sales activity.
    - Qualitative distortion: all gross receipts do not contribute to generation of income equally, so factors should reflect how receipts are actually earned.
    - Quantitative distortion: percentage change in apportionment factor comparing formulae advanced by taxpayer and FTB.
  - Manufacturing and brand management are key to producing income for PM USA, and these activities are reflected in the property and payroll factors, not the sales factor.
  - PM USA argued for the use of a three-factor formula with double-weighted property based on an independent economic analysis.
  - PM USA also argued that California's SSF formula violated the U.S. Constitution as applied.
  - The FTB denied PM USA's petition.

Alternative Apportionment
Relevant Cases

CarMax Auto Superstores West Coast, Inc. v. South Carolina Dep't of Revenue, 767 SE2d 195 (S.C. 2014)

- Where a party seeks to deviate from [the] statutory apportionment method, the proponent of such alternative apportionment method bears the burden of proving by a preponderance of the evidence that:
  1) the statutory formula does not fairly represent the taxpayer's business activity in South Carolina; and
  2) its alternative apportionment method is reasonable.

Equifax, Inc. v. Miss. Dep't of Revenue, 125 So 3d 36 (Miss. 2013)

- Supreme Court held that the Taxpayer bore the burden of proof, even when the state was the moving party.
- Miss. Code Ann. § 27-7-23(c)(2)(C): Legislative remedy
  - Burden on proponent of alternative apportionment.

Alternative Apportionment
Relevant Cases

- *Vodafone Americas Holdings, Inc. v. Roberts,* No. M2013-00947-SC-R11-CV, (Tenn. Mar. 23, 2016).
  - The Tennessee Supreme Court upheld the Court of Appeals' ruling that the Commissioner's imposition of an alternative market-based sourcing apportionment method is allowed when the statutory cost of performance method did not fairly represent the taxpayer's business activity in Tennessee.
  - The Tennessee Supreme Court found (1) the standard statutory tax apportionment provisions did not fairly represent Vodafone's Tennessee business activity; and (2) the alternative market-based sourcing method was reasonable.

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Multistate Update on Cases, Legislation, and Other Developments

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Disclaimer

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Content (agenda items)

- State of the states
- Cases before the US Supreme Court
- Federal developments with state implications
- Major legislative developments and trends
- Other trends to watch

State of the states

Revenue outlook

- US Census Bureau 19 September 2017 report on Q2 2017 – Property, Individual Income, and Sales Taxes Show Growth
  - Q2 2017 – taxes from property, corporate and individual income, and sales/use tax were up 1.7% from Q2 2016
  - Corporate income tax revenue was up 12.2% from Q2 2016
  - Individual income tax collections were down 1.1% from Q2 2016
  - Sales and gross receipts tax revenue was up 3.0% from Q2 2016
  - Estimated property tax collections were not statistically different from Q2 2016
- Rockefeller Institute: "State Tax Revenues in Flux" (June 2017)
  - Early figures for 2017 indicate stronger growth of state tax revenues as compared to 2016
  - State revenue forecast for FY 2018 remains weak, oil-dependent states hardest hit
  - Potential impact of federal tax reform, reduction of federal aid to states will have on states

Cases before the US Supreme Court

Judicial scorecard: Cases before the US Supreme Court (USSC)

State	Case name	Winner		Status
		State	Taxpayer	
California	*Gillette* (Compact election)	✓		Cert. petition denied by USSC
Colorado	*DMA (remote seller notice requirement)*	✓		Cert. petition denied by USSC
Delaware	*DE v. PA; AR v. DE* (Unclaimed property)			USSC has original jurisdiction
Florida	*American Business USA* (sales tax nexus)	✓		Cert. petition denied by USSC
Massachusetts	First Marblehead	✓		Cert. petition denied by USSC
Michigan	*IBM, Gillette, Sonoco* (among many others) (Compact retro repeal)	✓		Cert. petition denied by USSC
Michigan	*Self-Insurance Institute of America* (ERISA preemption)	✓		Cert. petition denied by USSC
Minnesota	*Kimberly-Clark* (Compact election)	✓		Cert. petition denied by USSC
Ohio	*Crutchfield, Newegg* and *Mason Companies* (bright-light nexus)	✓		**Case settled before cert. petition filed – NO USSC review**
Washington	*Dot Foods* (retroactive law change)	✓		Cert. petition denied by USSC
West Virginia	CSX Transportation (sales tax credit, internal consistency)		✓	Petition for writ of certiorari filed

Federal developments with state implications

Will states conform to any federal income tax law changes?

- Federal corporate income tax reform is expected to:
  - Broaden the tax base
  - Reduce tax rates
  - Repeal deferral of foreign earnings
  - Immediately tax previously untaxed accumulated foreign earnings and move to a territorial system
- The IRC typically is the starting point to determine state taxable income:
  - If the IRC changes (e.g., base expansion, elimination of deductions, modifications of credits), the state tax base may change as well.
- State differ on federal conformity:
  - “Fixed” conformity states = conformity not automatic (consider whether and when to conform)
  - “Rolling” conformity states = conformity automatic (consider whether to decouple)
  - “Selective” conformity states = conformity depends (consider whether and when to conform)

State income tax conformity to potential federal changes

Proposed federal change	Fixed states	Rolling states
Reduce the top corporate income tax rate (now 35%) and eliminate the corporate AMT	States do not conform to rate changes	States do not conform to rate changes
Reduce the top pass-through rate (now 39.6%)	States do not conform to rate changes	States do not conform to rate changes
Taxation of future foreign earnings - Territorial, 100% exemption for dividends paid from foreign subsidiaries; Border tax adjustment mechanism	Would have to proactively conform	Most states have separate DRD rules – proactive conformity may be required.
Mandatory tax, untaxed accumulated foreign earnings	Would have to proactively conform	Automatic conformity – would have to proactively uncouple (although if tax imposed through federal DRD rules, separate state conformity may be required.
Cost recovery - 100% expensing of tangible, intangible assets	Would have to proactively conform	Automatic conformity – would have to proactively uncouple
Interest - No current deduction will be allowed for net interest expense	Would have to proactively conform	Automatic conformity – would have to proactively uncouple
Other business provisions - Calls for them to generally be eliminated, except for research credit and LIFO	Would have to proactively conform	Since credits are not part of tax base, state likely would have to proactively conform

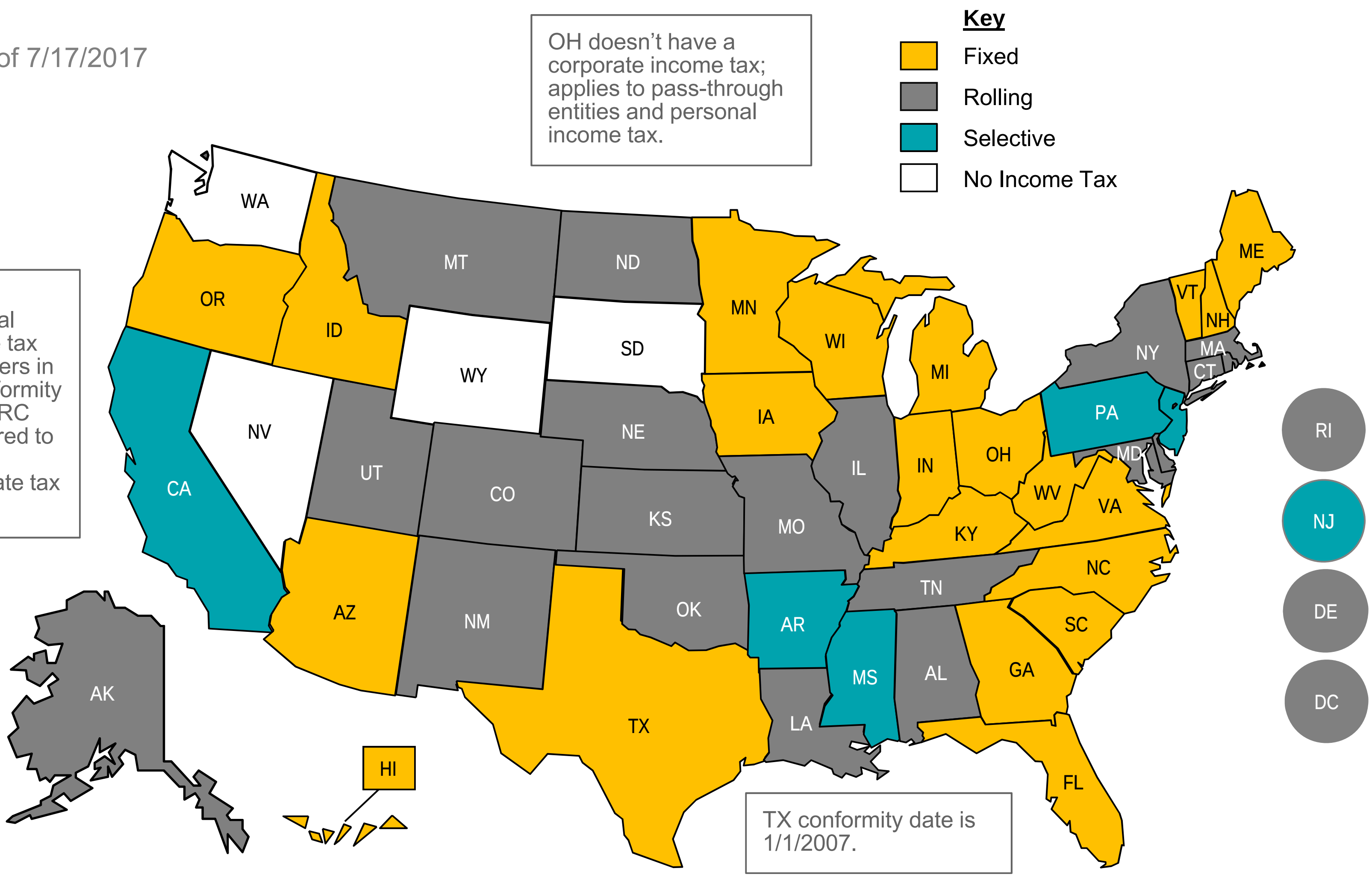
State income tax

Conformity to IRC

As of 7/17/2017

OH doesn't have a corporate income tax; applies to pass-through entities and personal income tax.

CA's personal income tax law differs in its conformity to the IRC compared to CA's corporate tax law.



TX conformity date is 1/1/2007.

Federal tax reform: state and indirect tax issues and considerations

- State income tax considerations surrounding treatment of foreign earnings
- State income tax provisions (including valuation allowances), including possible rising state effective tax rates, for financial statement purposes
- Problems with state conformity (or lack thereof) to the IRC § 385 debt-equity regulations
- Impact repeal of the Affordable Care Act will have on state budgets? State unemployment?
- What does federal tax reform mean for credits and incentives?

Federal legislation on state tax matters

- Mobile Workforce State Income Tax Simplification Act of 2017 (H.R. 1393/S. 540)
  - Passed House on 20 June 2017; under consideration in Senate
  - Would prohibit states from imposing income tax on nonresidents, and would prohibit subjecting that income to withholding and reporting requirements, unless the nonresident works in the state for more than 30 days during the calendar year
- Proposed Marketplace Fairness Act of 2017 (S. 976) and Remote Transactions Parity Act of 2017 (H.R. 2193)
  - Would subject remote sellers to sales tax liability
- No Regulation Without Representation Act of 2017 (H.R. 2887)
  - Would codify the *Quill* physical presence nexus standard for sales and use tax collection and reporting purposes, applicable to calendar quarters beginning on or after 1 January 2018

State conformity to IRS partnership audit reform

- Bipartisan Budget Act of 2015 (P.L. 114-74 enacted 2 November 2015) – Includes federal partnership audit reform
- So, what's changing?
  - Applies to partnership taxable years beginning after 31 December 2017
  - IRS can collect tax due at the ***entity level*** for all partnerships ***unless*** the partnership is eligible and elects out
    - Historically, while IRS could audit partnership, it could only collect and assess the partners.
    - New terms: "Reviewed Year" v. "Assessed Year"
  - Designated "tax matters partner" (now known as the "Partnership Representative") has ***sole*** authority to bind the partnership and any tax bill is responsibility of current year partners
- Problems?
  - Intergenerational partner problems because of IRS assessment at partnership level
  - Expect significant revisions to partnership and LLC management agreements

State conformity to IRS partnership audit reform

- Will the states conform?
  - Not automatically –
    - Most states conform to the IRC for the determination of taxable income, but not necessarily for administrative procedures.
    - States usually have their own administrative procedures.
    - Only one has a partnership audit manual – California FTB – and that only addresses federal taxation of partnerships.
  - Information sharing between IRS and states mean potential for more state audits.
  - We could see a wholesale change of state partnership tax rules.
  - Arizona (via SB 1288 from 2016) passed related legislation

Major legislative developments and trends

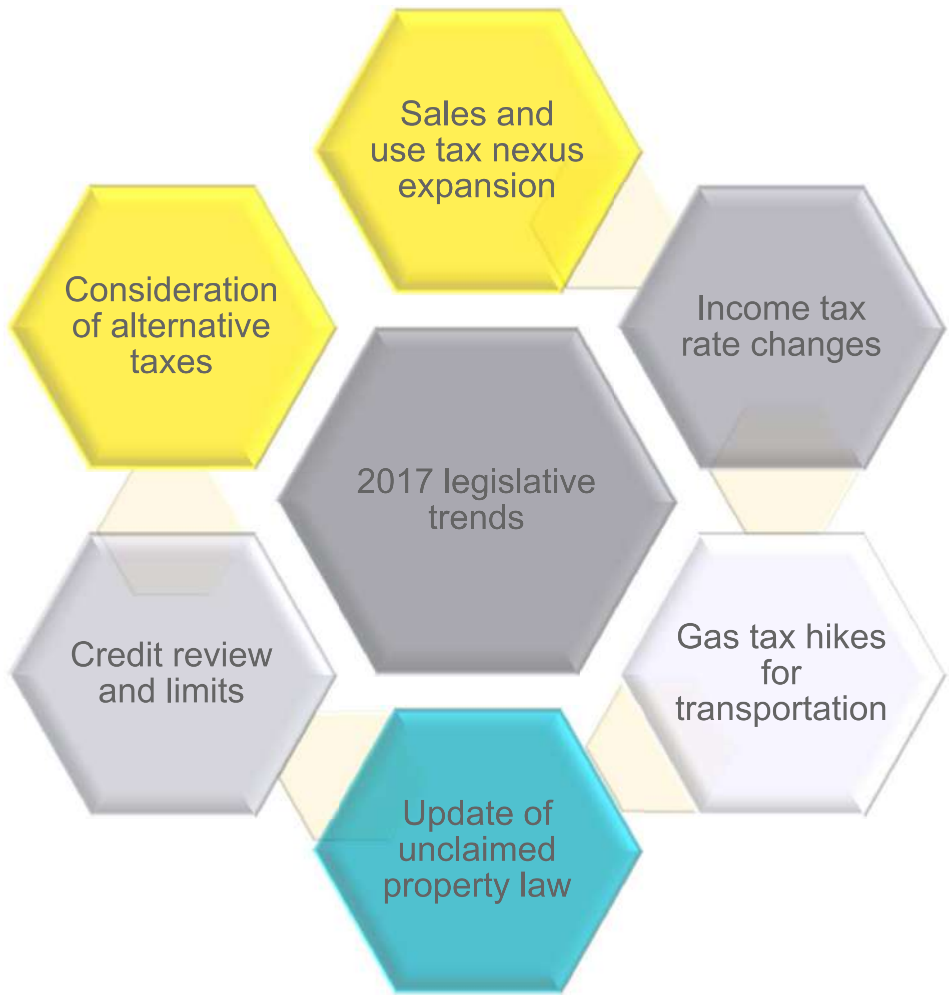
2017 legislative scorecard

Key: **Green** – enacted; **Red** – dead; **Purple** – vetoed; **Black** – proposed

As of 25 July 2017

Repeal/phase-out tax New tax	• Repeal Corporate income/franchise: OK; Individual Income Tax: ME, MT, WV; Sales/Use Tax WV • Phase-out – LA (corporate franchise tax); MI (personal income tax); TX (Margin Tax); WV (corporate income tax) • New: AK (personal income tax); LA (CAT, Margin); MT (sales tax); OR (gross receipts tax); WV (CAT) (Consumption tax)
Rates	• Increase: Corporate income: DE, IL, OR, WV; Personal income: HI (high income) IL, KS (repeal pass-through exemption), Seattle, WA (new, high wage); Sales/use: CT, OH, WV; B&O: WA; Fuel: CA, IN, SC, TN, WV • Decrease: Corporate income: FL (corp. tax exemption), ID, IL, LA, ME, MO, NE, NH (business profits & business enterprise) NC, PA, TX; Personal income: AR, CA, GA (flat income tax rate), HI (low income), ID, ME, NE, NC, OH, WI; B&O: WA
Nexus	• Sales/use Affiliate/click-through remote retailers: ID, NM, SC, UT • Sales/use Economic nexus: AR, FL, GA, HI, IN, ME, MS (legislation failed, now considering reg.), NE, NM, NC, ND (contingent effective date), OH, UT, WA, WY • Marketplace provider: MN, NY, RI, TX, WA • Other nexus: MS (expand doing business – income tax); VA (inventory in state – sales tax); WA (expand B&O economic nexus)
Income tax	• Market sourcing: AR, KY, MS, MT, NM, NC, OR, VA, WI • Single sales factor (SSF): MA (financial institutions), OR, TN (manufacturer), VA • Combined reporting: AL, KY, MD, MO, NM, OK, PA; CA (eliminate water's edge), MA (adopt worldwide), MT (eliminate water's edge), • Tax havens: AL, IL, KY, ME, MA, MN, PA; OR (modify current provision) • Miscellaneous: HI (REIT dividend paid deduction); IN (alternative apportionment): AR (throwout); KY, MD, NJ (throwback); MN (close loopholes); PA (30% cap on NOLs): MT, WI (modify NOLs); MS (dividends received deduction); OR (disclosure)
Sales tax	• Tax services: CA, GA (ride sharing), IL, KS, LA, ME, NE, NY (ride sharing), NM (medical and hospital), OH, OK, UT, WV • Digital goods: AL, AR • Daily remittance of sales tax: CT, MA • Eliminate/limit some exemptions: AZ, AR, LA, PA, UT, WA • Expand exemptions: CA (manufacturing, R&D); FL (online streaming), UT (expand machinery and equipment exemption), WY (extend machinery exemption) • Remote retailer notification: AL, AR, HI, KS, NE, PA, PR, UT, WA; CO (repeal current provisions)
Property tax	• Property tax relief: ID (increase personal property tax exemption), IL (freeze rate), MN, TX (cap), WI (repeal business personal property tax)
Other	• Amend credits: AL (jobs), AZ (jobs, R&D), AR (various), CT (review), FL (jobs), GA (investment), HI (film), IL (R&D), LA (various), MD (energy, investment), MI (jobs), MN (R&D) MT (jobs), NY (various), OK (wind), RI (film credit), TN (various), • Federal partnership audit rules: GA, MN, MT • Carbon tax: MA, NH, OR, RI, VT, WA • CEO pay: CT, IL, MN, RI; San Francisco • Miscellaneous: CT, OH, VA (amnesty); WA (tax court); MI, TX, WI (dark store); AR, DE, ID, IL, NJ, NC, SD, TN, TX, UT (unclaimed property)

2017 legislative trends



California overhauls State Board of Equalization (SBE)

AB 102 *"Taxpayer Transparency and Fairness Act of 2017"* (enacted 27 June 2017)

- Following a critical report from the California Department of Finance, state legislature enacted and governor signed legislation overhauling the SBE
- Generally effective 1 July 2017
  - SBE appeals authority transferred to Office of Tax Appeals (OTA) effective 1 January 2018)
- Relieves the SBE of most (more than 90%) of its duties relating to the administration of many state taxes and fees
  - Including the responsibility to hear appeals of personal income and corporate franchise and income tax matters transferred to OTA
- SBE retains its constitutional authority over state assessed property tax, as well as insurance and alcohol taxes
- Creates two new tax agencies:
  - California Department of Tax and Fee Administration (CDTFA)
  - OTA
- Franchise Tax Board (FTB) unaffected by the legislation

California Department of Tax and Fee Administration (CDTFA)

- Many of the SBE's tax administrative responsibilities are being assumed by the newly created CDTFA, including administration of sales and use tax
- CDTFA will have to create new tax forms
  - New "Claim for Refund or Credit" and "Petition for Redetermination" forms are now available
- Most of the SBE's employees transferred to CDTFA already
- Governor Jerry Brown appointed
  - Nicolas Maduros, Dir. of CDTFA
  - Tad Egawa, CDTFA Chief Counsel
  - Maduros appointment requires Senate confirmation
- New website: http://www.cdtfa.ca.gov/

California Office of Tax Appeals (OTA)

- OTA assumes SBE's administrative tax appeals function
- Governor appoints Director, Deputy Director and the Chief Counsel, with the Director subject to Senate confirmation
- OTA will establish tax appeals offices in Northern, Central, and Southern CA
- Tax appeal panels will be presided over by panels of three administrative law judges (ALJs)
  - Not clear how many panels there will be but OTA has only been appropriated $5m budget
- Legislation specifically provides that anyone over the age of 18 can represent a taxpayer before the OTA, including attorneys and accountants
- OTA is required to publish a written opinion for each appeal decided by a tax appeals panel
- OTA created on 1 July 2017, **but** SBE will continue to hear tax appeals until 1 January 2018
  - Allow OTA time to employ ALJs and staff

Override of Governor's veto: Illinois

Tax increase

SB 9 (enacted over the Governor's veto on 6 July 2017) tax provisions of FY2018 Budget. Key changes:

- Increase by 33% both the corporate and personal income tax rates, effective 1 July 2017
  - Permanently increase the corporate income tax rate to 7.0% (from 5.25%)
    - When combined with the 2.5% personal property replacement tax, the effective tax rate on corporations is **9.5% on income apportioned or allocated to IL**
  - Permanently increase the individual income tax rate to 4.95% (from 3.75%)
- Expand the manufacturing and assembling machinery and equipment exemption to include graphic arts machinery and equipment, beginning 1 July 2017
- Eliminating the like-apportionment rule for all taxpayers
- Restore the R&D credit through 2021
- Decouple from the IRC §199 production deduction, effective for taxable years ending on or after 31 December 2017

Override of Governor's veto: Kansas

Tax increase

SB 30 (enacted over the Governor's veto on 6 June 2017)

- Experiment over: Repeals the individual income tax exemption for pass-through entity income (non-wage business income of individuals reported by partnerships, LLCs, S corporations, and sole proprietorships)
- Eliminates individual income tax rate cuts scheduled to take effect beginning in 2018; instead, rates are increased by creation of a new, third income tax bracket of 5.2% (increased to 5.7% in 2018)
- Adds items that can be taken as itemized deductions (e.g., charitable, mortgage interest, property tax, and medical care expenses (starting in 2018)) and increases the amount that can be claimed with full allowance by 2020
- Addback no longer required for the federal net operating loss (NOL) deduction in determining Kansas taxable income for individual income tax purposes
  - The federal NOL deduction, however, still must be added back to federal adjusted gross income (AGI) for corporate income tax purposes
- Above provisions apply retroactively to beginning of 2017
- Penalty and interest relief on any underpayments of estimated or withheld tax due to the rate changes or income tax adjustments as long as the underpayment is resolved by 17 April 2018

Override of Governor’s veto: North Carolina
Tax decrease

SB 257 (enacted over the Governor’s veto on 28 June 2017), key tax provisions:

- ► Reduce the corporate income tax rate to 2.5% (from 3.0%), effective for tax years beginning on or after 1 January 2019
- ► Reduce the franchise tax rate for S corporations
- ► Lower the personal income tax rate from 5.499% to 5.25% and increases the standard deduction, starting in 2019
- ► Eliminate the existing 1% privilege (sales) tax on certain purchases of manufacturing equipment and machinery
- ► Exempt from tax the sales of certain equipment, or an accessory, an attachment, or a repair part for equipment used at a fulfillment center
- ► *NOT included* in the budget bill – market-based sourcing provisions; may be reconsidered in 2018

Sales and use tax nexus and compliance update

- Notice and reporting requirements
  - Effective 1 July 2017: Colorado, Louisiana, Vermont and Puerto Rico require remote sellers with no physical presence to comply with notice and reporting provisions
  - Connecticut has begun demanding customer information from non-nexus remote sellers without enactment of new legislation
- Economic nexus
  - *South Dakota v. Wayfair Inc., Overstock.com, Inc*. and *Newegg Inc*. was heard by South Dakota Supreme Court – SB 106's sales tax economic nexus provision unconstitutional
- Federal legislation
  - House bill to codify the *Quill* physical presence standard had a hearing before the House Judiciary Committee
  - Two bills (House and Senate versions) to allow states to compel non-nexus remote sellers to collect and remit sales or use tax have been introduced with no subsequent action

Sales and use tax nexus and compliance update

- Marketplace Provider Act provisions
  - Expand definition of "retailer maintaining a place of business in the state" to include any retailer that has an in-state marketplace provider or other third party operating under the authority of the retailer or its subsidiary, for any purpose, including the facilitation or processing of sales
  - Passed in Minnesota and Washington State; failed in New Mexico, New York, North Carolina and Texas
- Presence through "cookies"
  - Massachusetts Directive 17-1 repealed, to be reintroduced via regulation
  - Ohio 2017-18 Budget (said to not target cookies)
  - *Quill* rejected notion that a few floppy disks in the state ("licensing of software") met the substantial nexus test (footnote 8); Massachusetts sought to distinguish

Other trends to watch

Nexus

Economic nexus (adopted since 2007)

Bright-line/factor presence

- Bright-line sales factor presence standards adopted
  - Alabama – effective 1 January 2015
  - California – effective 1 January 2011
  - Colorado – effective 30 April 2010
  - Michigan – effective 1 January 2008
  - Nevada – effective 1 July 2015 (Commerce Tax)
  - New York – for credit card banks only effective 1 January 2008; expanded to all Article 9-A taxpayers effective 1 January 2015
  - New York City – for credit card banks only effective 1 January 2011
  - Ohio – effective 1 July 2005 (Commercial Activity Tax)
  - Tennessee – effective 1 January 2016 (but see *J.C. Penney*, which requires physical presence)
  - Washington – effective 1 June 2010 (Business & Occupation Tax)

Economic nexus (adopted since 2007)
Purposeful direction

- Purposeful direction of business to the state/doing business in the state
  - Connecticut – effective 1 January 2010*
  - New Hampshire – effective 1 July 2007
  - Oregon – effective 8 May 2008
  - Rhode Island – effective 12 January 2016
  - Wisconsin – effective 1 January 2009

  *Does not apply to foreign corporations unless they have effectively connected income – effective 1 January 2011

Nexus: judicial developments

- **California** – *Swart Enterprises, Inc.* (Cal. Ct. App. 12 January 2017) – Iowa corporation was not doing business in state under California's prior doing business standard when its only connection was a limited investment in LLC with San Francisco business address
  - FTB Notice 2017-01 (28 February 2017) – State announced it would not appeal *Swart* and would apply it "in situations with the same effects"
- **Colorado** – *Target Brands, Inc.* (Colo. Dist. Ct. 27 January 2017) – Out-of-state intangible holding company's payments under an intellectual property license agreement tied to in-store sales established substantial nexus
- **Oregon** – *Cheng Shin Rubber* (Or. Tax Ct. 31 March 2017) – Nexus created for out-of-state wholesale tire distributor because activities of in-state third party that provided warranty services on the wholesaler's behalf exceeded the protections of Pub. L. 86-272

Nexus: administrative developments

- **Florida** – TAA No. 17C1-001 (13 January 2017) – Out-of-state reinsurer did not have nexus with Florida because it was not an approved reinsurer, was not registered in Florida, and its in-state affiliates were not domiciled or commercially domiciled in Florida
- **Massachusetts** – TIR 17-2 (16 February 2017) – Holding shareholder meetings or boards of directors meetings by offshore investment companies in Massachusetts will not, by themselves, result in the offshore investment company being treated as doing business in Massachusetts
- **New Mexico** –*Aventis Pharmaceuticals Inc.* (N.M. Taxn. and Rev. Dept. 19 May 2017) – Collaborative work with external parties and hospitals exceeded P.L. 86-272 protections; Related company's sponsorship of instate clinical trials is attributable to the entities as this activity helped further the entities' brand and market potential

Expanding the Filing Group

State Transfer Pricing Activity

- **Multistate Tax Commission's** State Intercompany Transaction Advisory Service Committee
  - Five states have formally committed (AL, IA, NJ, NC and PA)
  - Early implementation steps: training, information exchange, case discussion
- Some states have enacted a statutory provision similar to IRC Section 482, while other states have adopted (explicitly or implicitly) IRC Section 482
- States without an intangible addback may exercise these powers as a mechanism to force combination (or some settlement) related to intangible expense deductions

Tax Haven Legislation in States

- Tax haven laws generally require a corporation to include in its water's-edge return the income and apportionment factors of unitary corporate affiliates formed or engaged in business in "tax havens"
  - Intent of these laws is to prevent multinational corporations from avoiding state income taxation by shifting domestically earned income to tax haven affiliates
  - Are these laws constitutional?

- States considering combined reporting legislation tend to include tax haven language
  - Recently enacted: CT, DC, RI, WV
  - Considered: AL, KY, NJ, PA

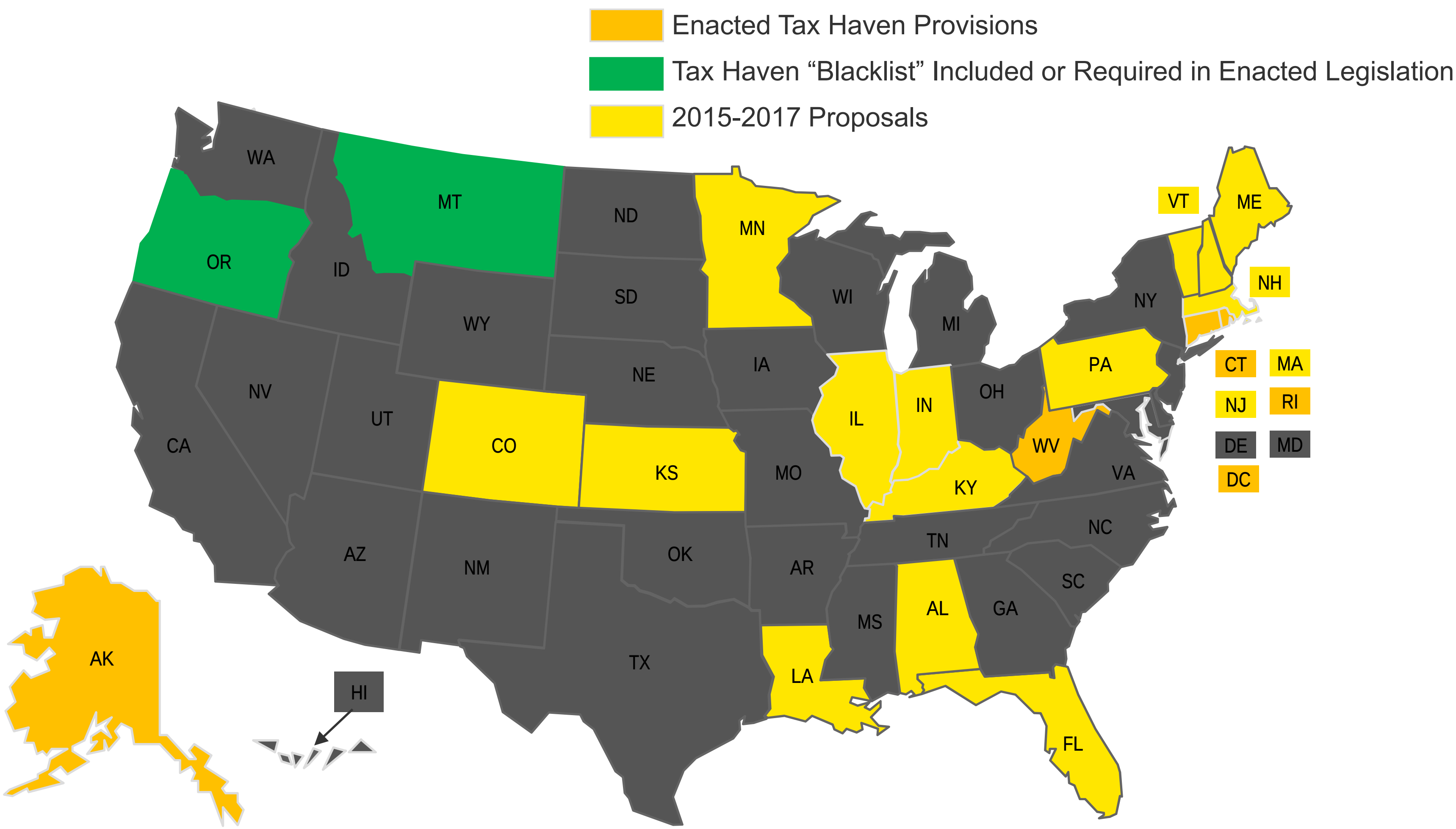
MTC's Definition of "Tax Haven"

- "Tax haven" is a jurisdiction that, during the tax year has no or nominal effective tax on the relevant income and:
  - Has laws or practices that prevent effective exchange of information for tax purposes with other governments on taxpayers benefiting from the tax regime;
  - Has a tax regime which lacks transparency;
  - Facilitates the establishment of foreign-owned entities without the need for a local substantive presence or prohibits these entities from having any commercial impact on the local economy;
  - Explicitly or implicitly excludes the jurisdiction's resident taxpayers from taking advantage of the tax regime's benefits or prohibits enterprises that benefit from the regime from operating in the jurisdiction's domestic market; or
  - Has created a tax regime which is favorable for tax avoidance

Approaches to Identify Tax Havens

- There is no single agreed-upon definition of a tax haven
- States have generally adopted one of the following approaches to identify tax havens
  - Blacklist approach (e.g., MT, OR)
  - Factor or criteria approach (e.g., AK, CT, RI, WV)

Tax Haven State Enactment Status, with 2015-2017 Proposals



California considered tax haven legislation in 2010, but after much lobbying by the U.S. State Department and foreign ambassadors from affected countries (e.g., Ireland and the Netherlands), the effort was dropped.

Arguments for and against Tax Haven Legislation

- Arguments <u>for</u> tax haven legislation
  - $20 billion in state tax revenue loss
  - Belief that multinationals hide profits in “island economies”
  - Big business does not pay its “fair share”
  - Small business disadvantaged since unable to use tax haven “loophole”

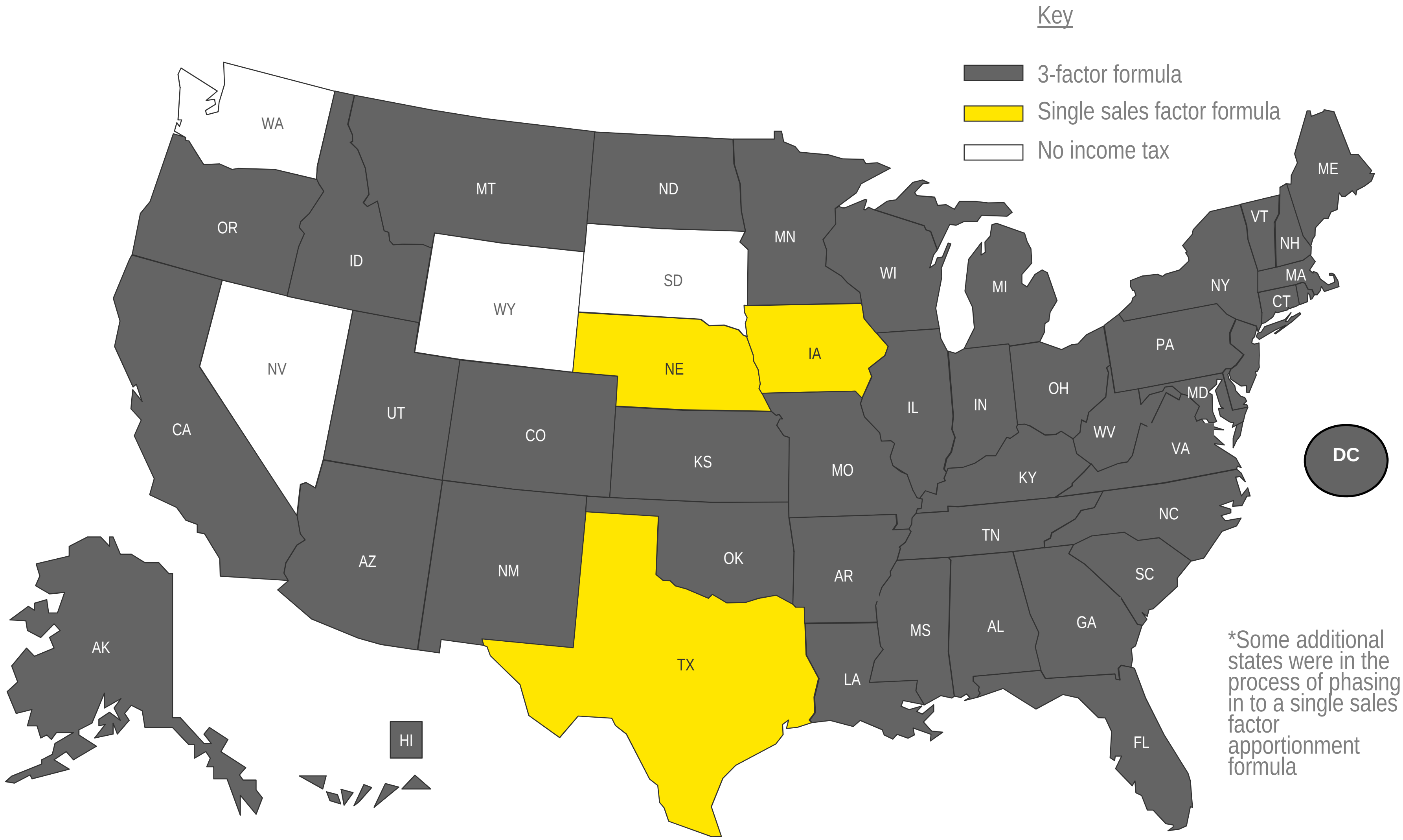
- Arguments <u>against</u> tax haven legislation
  - Tax haven “blacklisting” is arbitrary and unmanageable
  - No clear evidence that profit shifting to tax havens is eroding the state corporate tax base
  - The business share of state and local taxes is actually increasing
  - States should not return to a form of worldwide combination
  - States are adopting a go-it-alone approach that is out of sync with the rest of the international community

Allocation, apportionment and sourcing

Business/nonbusiness income

- **All states** – Multistate Tax Comn., Model General Allocation and Apportionment Regulations (amended 24 February 2017) – Adopted amendments change the terms "business income" to "apportionable income" and "nonbusiness income" to "nonapportionable income"
  - Amends "apportionable income" definition to reference to constitutional standard to determine what income is subject to apportionment and clarify the transactional and functional tests included in the definition
  - States do not automatically adopt these changes
  - Montana and Oregon have adopted
- **New Jersey** – *Xylem Dewatering Solutions, Inc.* (NJ Tax Ct. 7 April 2017) – Gain on sale of S Corp. stock that buyer and S Corp. shareholders elected under IRC §338(h)(10) to treat as deemed sale of S Corp. assets is allocated to New Jersey as non-operational income; filing retroactive S Corp. election was consent of non-original shareholders to New Jersey taxation
- **Oregon** – HB 2275 (enacted 15 May 2017) – Aligns income subject to apportionment with MTC model, starting in 2018

2000: states with a 3-factor formula



*Some additional states were in the process of phasing in to a single sales factor apportionment formula

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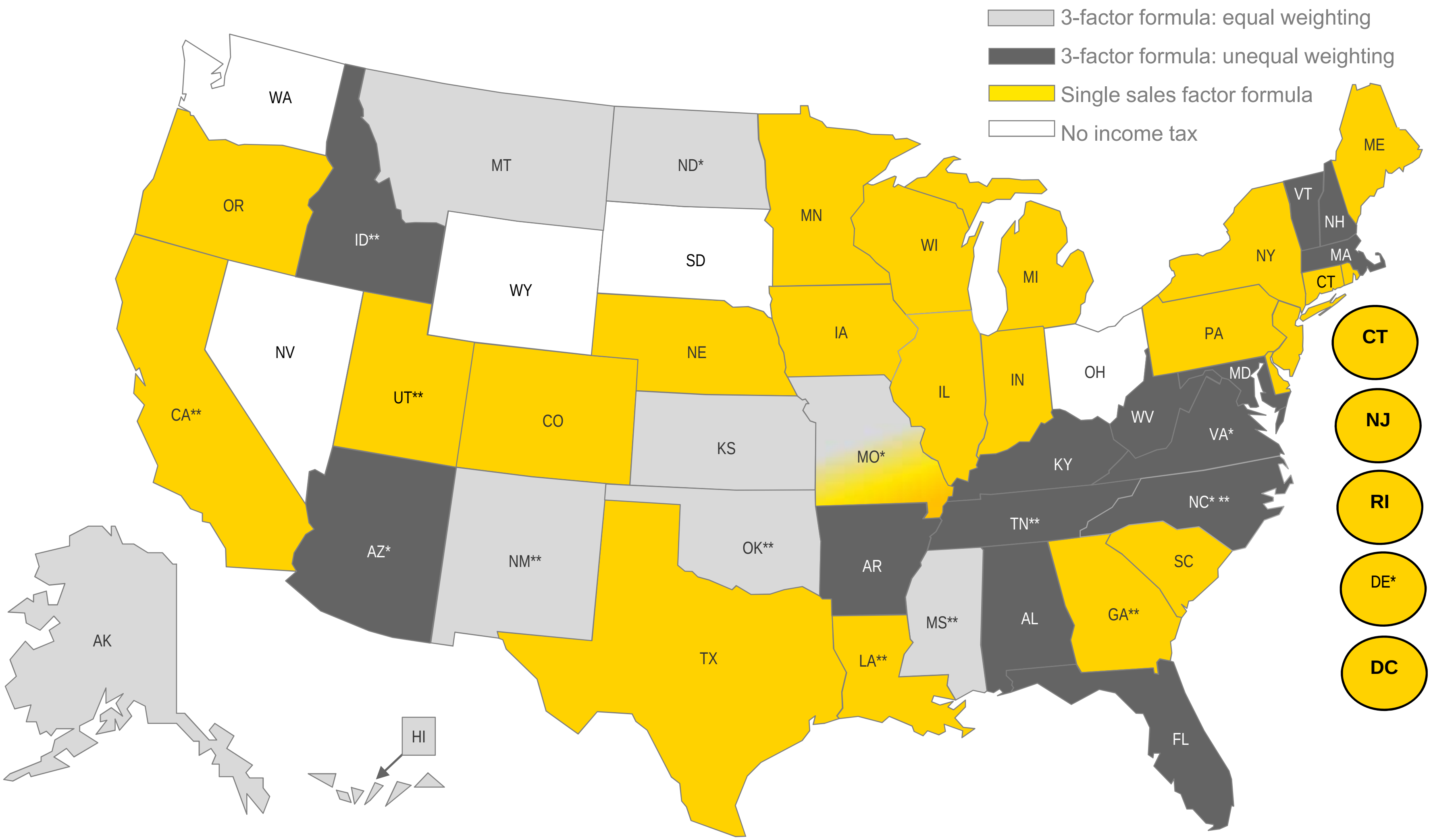
2017: states with a 3-factor formula

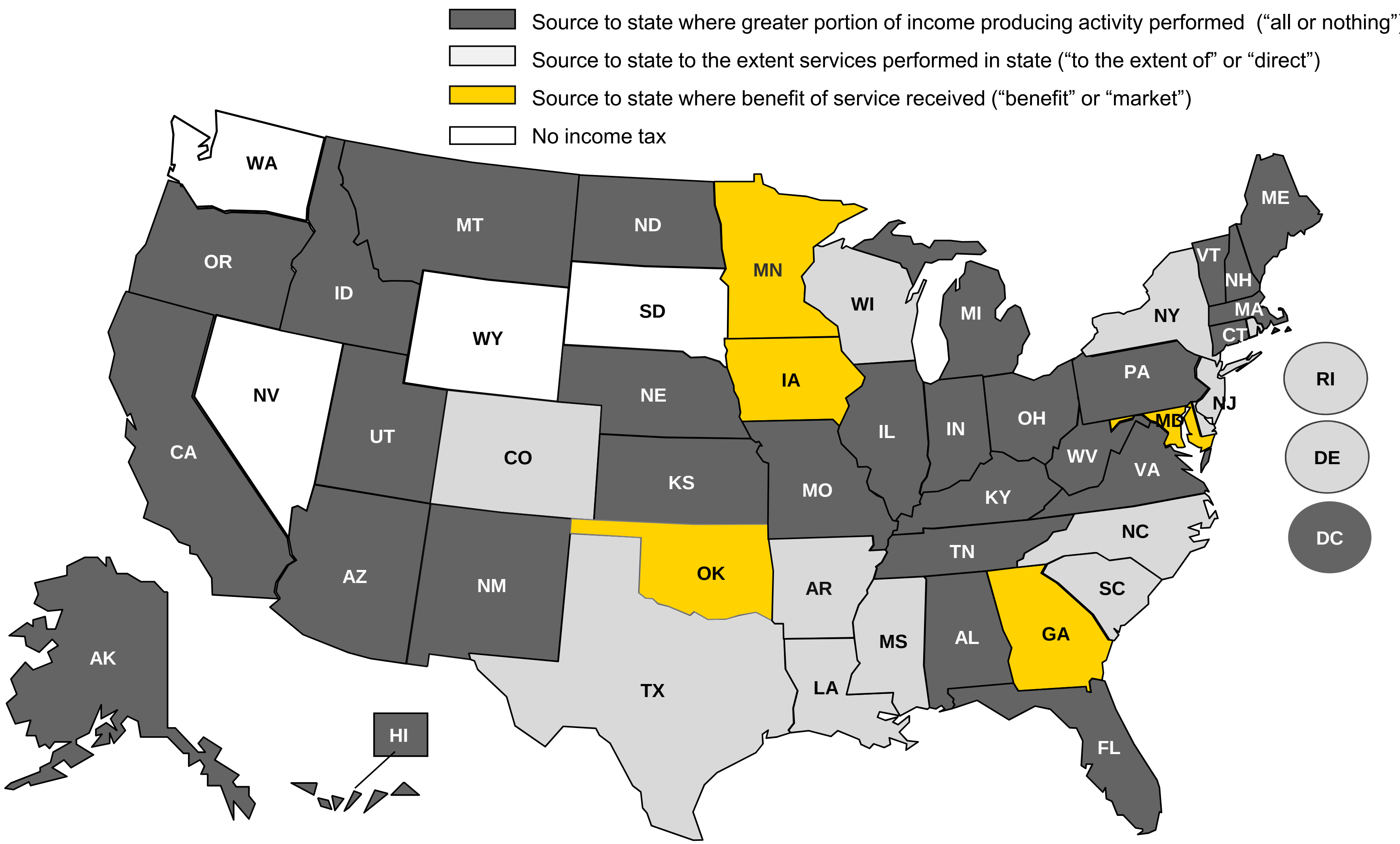
As of 17 July 2017



*Single sales factor is either electable or being phased-in

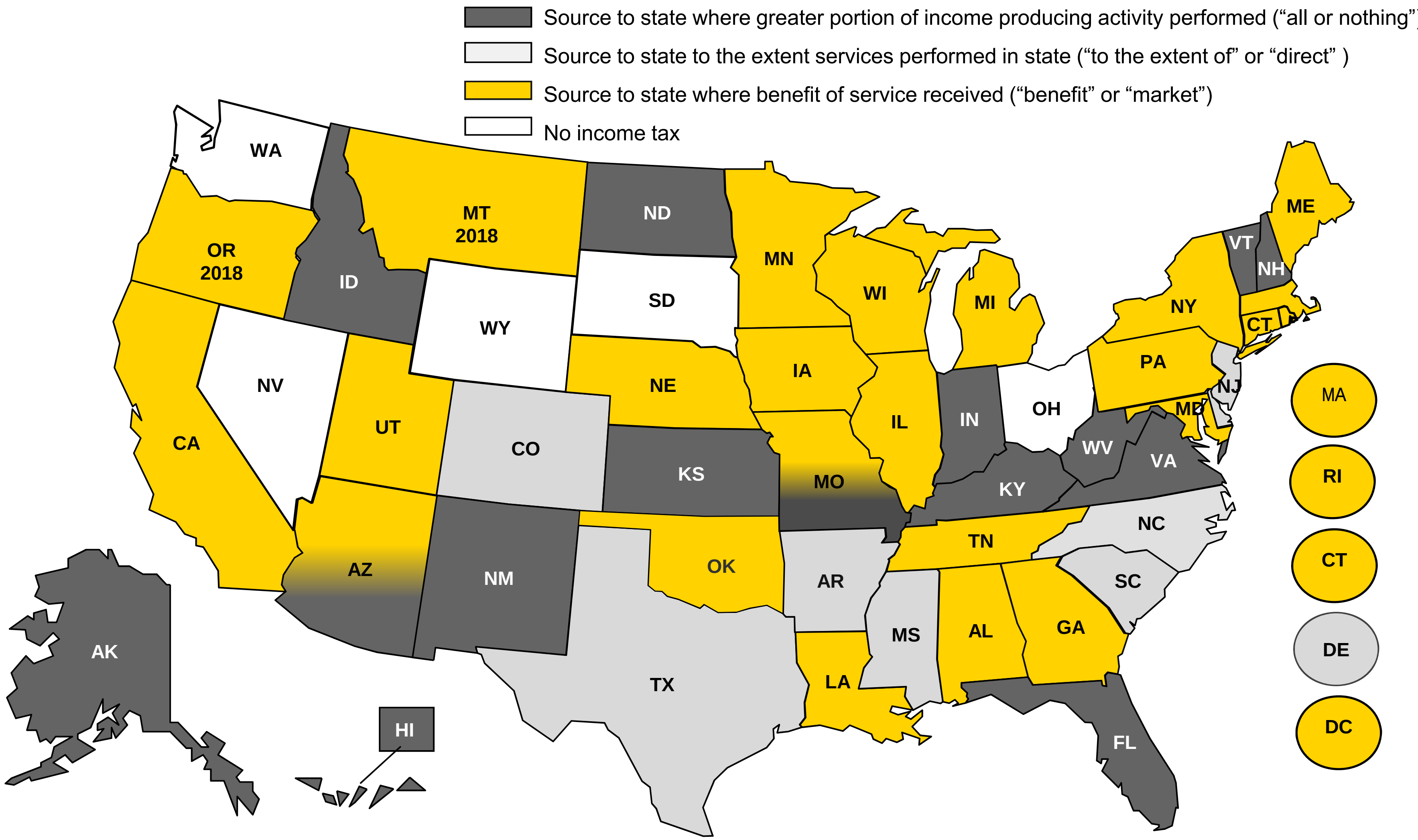
**Different apportionment rules apply to certain industries

2000: sourcing of multistate service revenue



2017: sourcing of multistate service revenue

As of 17 July 2017



Increase the sales factor and move to market-based sourcing

- Sales factor changes
  - Single sales factor (SSF) adopted: California, Connecticut (2016), District of Columbia, Louisiana (2016), Michigan, Minnesota, New Jersey, New York (expanded to FSI, 2015), Pennsylvania, Rhode Island
  - SSF being phased-in: Delaware (by 2020), New York City, North Carolina, North Dakota, City of Philadelphia, Utah
  - SSF (elective): Arizona, New Mexico, North Dakota
  - SSF-specific industry or as an incentive: Florida, Tennessee, Virginia
  - Increased-weighted sales factor: Alabama (double weighted), North Dakota (double weighted, 2016-2017), Tennessee (triple weighted), Utah (expanded to automobile manufacturing)
- Market sourcing adopted
  - Alabama, Arizona (phased-in election for multistate service providers), California (tied to SSF), Connecticut (2016), District of Columbia, Louisiana (2016), Massachusetts, Montana (2018), Nebraska, New York (2015), Oregon (2018), Pennsylvania, Rhode Island, South Dakota, Tennessee (2016)

Market-based sourcing

- **All states** – Multistate Tax Comn., Model General Allocation and Apportionment Regulations (amended 24 February 2017) – Repealed cost of performance sourcing rule for sales of non-tangible property; replaced with new market-based sourcing provisions based on those adopted by Massachusetts
  - States do not automatically adopt this change
- **California**
  - FTB, proposed CCR tit. 18 § 25136-2 (second interested parties meeting 16 June 2017) – Discussed additional amendments to the recently amended market-based sourcing regulations
  - FTB, Notice 2017-02 (29 March 2017) – Guidance on requesting relief from late payment penalty attributable to recently adopted amendments to market-based sourcing regulations

Market-based sourcing

- **Connecticut** – Special Notice 2017(1) (17 April 2017) – Guidance on changes to apportionment provisions (i.e., adoption of market-based sourcing) that apply to corporations (2016) and individuals (2017)
- **Montana** – HB 511 (enacted 3 May 2017) – Adopts market-based sourcing provisions for tax years beginning on and after 1 January 2018
- **North Carolina** – 17 N.C. Admin. Code 05G.0101 (adopted 16 February 2017) – Rules Review Committee approved revenue department's proposed market-based sourcing rules for non-tangible personal property and services; next steps are legislature approval and publication in North Carolina Register
- **Oregon** – SB 28 (enacted 3 July 2017) – Replaces the current cost of performance method for sourcing sales of intangible property and services with a market-based sourcing method, applicable to tax years beginning on or after 1 January 2018

Judicial scorecard: Multistate Tax Compact apportionment election cases

State	Case name	Winner		Status
		State	Taxpayer	
California	*Gillette*	✓		Cert. petition denied by US Supreme Court; see FTB Notice 2016-03
Colorado	*Sherwin Williams*	✓		Case dismissed by District Court, Denver County on 18 November 2016; other cases pending
Michigan (MBT)*	*IBM*		✓ …but	Only IBM won and only for 2008, all other claims subject to retroactive repeal legislation
Michigan (Compact retro repeal)	*IBM, Gillette, Sonoco* (among many others)	✓		Cert. petition denied by US Supreme Court
Michigan (SBT)**	*AK Steel*		✓	State will not appeal ruling
Minnesota	*Kimberly-Clark*	✓		Cert. petition denied by US Supreme Court
Oregon	*Health Net*	✓		Or. S. Ct. heard arguments 19 September 2016
Texas	*Graphic Packaging*	✓		Tex. App. Ct.; Tex. S. Ct. granted cert.

*MBT – Michigan Business Tax; **SBT – Single Business Tax

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Chapter 5
Advanced Tax Law Course
August 17, 2017
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AWARDS & RECOGNITIONS

- Board Certified in Tax Law by the Texas Board of Legal Specialization
- Board Certified in Estate Planning and Probate Law by the Texas Board of Legal Specialization
- Fellow, American Bar Association Section of Real Property, Trust and Estate Law, 2015-2017
- Rookie of the Year, Tax Section of the State Bar of Texas, 2015-2016
- Outstanding Substantive Committee Chair, Tax Section of the State Bar of Texas, 2016-2017
- Tax Leadership Academy 2016—2017, Tax Section of the State Bar of Texas
- Texas Rising Star 2015, 2016, & 2017

PUBLICATIONS

- *Inbound Tax Planning: What Your Clients Need To Know Before Immigrating*, Today's CPA, Part I January/February 2017, Part II March/April 2017
- *Estate and Gift Taxation of Nonresidents*, Probate & Property, November/December 2016
- *Split-Interest Charitable Trusts: An Introduction to CLTs and CRTS*, Probate & Property, January/February 2015
- *Now, How Do I Decant a Trust?* Real Estate, Probate, and Trust Law Reporter, December 2013
- *Swimming Against the Stream: Advising Clients on Their IRA Options*, Probate & Property, July/August 2011

PRESENTATIONS

- Customer Service: Taking Your Business to the Next Level by Defining the Customer's Experience, DCATX, June 24, 2017
- International Returns for "Foreign" Trusts: Identifying and Planning Around Tax Traps, State Bar of Texas Annual Meeting—Tax Section, June 23, 2017
- Tax Treaties, Wednesday Tax Forum, May 30, 2017
- Fundamentals of Trust Administration and Fiduciary Income Taxation, American Bar Association webinar, May 25, 2017
- Post-Mortem Tax Planning, Crady, Jewett & McCulley LLP breakfast seminar, May 25, 2017
- Tax Treaties, Society of Trust and Estate Practitioners, Texas Chapter meeting, March 9, 2017
- Leaving the United States: Tax Issues on Departure, Estate Planning Council of Central Texas, January 17, 2017
- Trust Distributions to Foreign Beneficiaries: Mastering Complex Planning and Calculation Challenges, Strafford Publications webinar, January 5, 2017
- Divorce Can Be Taxing, Crady, Jewett & McCulley LLP's 28th Annual Tax Planning Seminar, November 10, 2016
- International Tax Issues for Form 1040, Crady, Jewett & McCulley LLP's 28th Annual Tax Planning Seminar, November 10, 2016
- Current Developments in International Estate Planning, International Tax Committee of the State Bar of Texas Tax, 19th Annual International Tax Symposium, November 3-4, 2016
- Foreign Investment in U.S. Real Property: Tax and Reporting Challenges, Strafford Publications webinar, November 1, 2016

- Getting International Returns Right The First Time, TexasBarCLE, 34th Annual Advanced Tax Law Course, October 26, 2016
- Getting International Returns Right The First Time, Wednesday Tax Forum, October 11, 2016
- A Sun That Never Sets: International Tax Issues for Global Clients, TexasBarCLE, 40th Annual Advanced Estate Planning and Probate Law Course, June 22, 2016
- Strategies for Dealing with Trust UNI: How to Prevent Income Tax Armageddon, ABA Tax Section Midyear Meeting, January 30, 2016
- Estate & Gift Tax Treaties, International Tax Committee of the State Bar of Texas Tax, 18th Annual International Tax Symposium, November 12-13, 2015
- International Tax Treaties, TexasBarCLE, 33rd Annual Advanced Tax Law Course, October 30, 2015
- Anatomy of a Trust Agreement, Crady, Jewett & McCulley LLP's 27th Annual Tax Planning Seminar, October 22, 2015
- Charitable Lead Trusts and Charitable Remainder Trusts: Tax Benefits & Administration Issues, Midland Odessa Business and Estate Council, October 20, 2015
- Estate & Gift Tax Treaties, International Tax Forum of Houston, Houston, Texas, August 6, 2015
- Pre-Immigration Tax Planning For U.S. Immigrants, Wednesday Tax Forum, July 28, 2015
- Foreign Investment in U.S. Real Property: Tax and Reporting Challenges, Strafford Publications webinar, July 21, 2015
- Charitable Lead Trusts and Charitable Remainder Trusts: Tax Benefits & Administration Issues, Estate Planning Seminar, Midland Memorial Hospital Foundation, May 7, 2015
- Pre-Immigration Tax Planning For U.S. Immigrants, Houston Chapter of the American Association of Attorney-Certified Public Accountants, April 24, 2015
- Tax Planning for U.S. Immigrants, Houston Attorneys in Tax and Probate, March 3, 2015
- Charitable Lead Trusts and Charitable Remainder Trusts: Creation, Funding, and Administration, TexasBarCLE, 32nd Annual Advanced Tax Law Course, August 29, 2014
- Split-Interest Charitable Trusts: What You Need to Know About CLTs and CRTs, TexasBarCLE Intermediate Estate Planning & Probate Course, June 9, 2014
- Federal Income and Wealth Transfer Tax Planning for U.S. Immigrants, Houston Trusts & Estates Club, March 20, 2014

PROFESSIONAL & CIVIC AFFILIATIONS

- American Bar Association
  - Section of Real Property, Trust & Estate Law, International Tax Planning Committee, Vice-Chair 2017-2018
- State Bar of Texas
  - Tax Section, Elected Council Member, 2017-2020
  - International Tax Committee, Chair 2015-2016 & Co-Chair 2016-2018
  - Advanced Tax CLE Planning Committee, Member 2014, 2015, 2016, & 2017
- Houston Bar Association
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  - John J. Eikenburg Law Week Fun Run, Planning Committee Member, 2014- 2017
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- Member of the 50 States Marathon Club, the Marathon Maniacs, & the 50Sub4 Marathon Club

ADDITIONAL INFORMATION

- I was the Night Manager for the Four Seasons Hotel in Austin for three years before law school.
- In the past five years, I have run the Boston Marathon, adopted Griswold from Red Collar Rescue, and spent my honeymoon backpacking through Southeast Asia.
- I enjoy the works of George R.R. Martin, Wes Anderson, Robert Heinlein, & Bill Murray.

TABLE OF CONTENTS

I. Introduction

As if the rules applicable to taxation weren't complicated enough, the rules change when money and capital starts crossing borders. The digital economy makes it easy for people and money to move across international borders. Most of the time, this movement will not have an impact on a person's tax situation, and a nonresident of the United States would have few, if any, interactions with the Internal Revenue Service ("IRS"). But upon becoming a "resident" of the U.S. for tax purposes, the rules change dramatically, and if not planned for, the tax consequences can be severe.

But layered on top of this complexity is the United States' network of bilateral income tax treaties. Each treaty provides tax benefits to the residents of foreign countries for income generated within the United States. Because each treaty is the result of individual negotiations between the United States and the treaty partner and based on the particulars of the relationship between the two nations, each treaty is unique and produces a unique tax regime that may differ substantially from the normal rules of international taxation.

But to make things really fun, we then layer on top of this complexity the tax laws that apply when a trustee or other fiduciary first receives the income before making a distribution of that income to a beneficiary. Trusts and estates are subject to a different tax scheme that is a hybrid of the entity and individual tax systems that allocates the responsibility for paying tax on income between the fiduciary and the beneficiary.

II. Income Taxation of Nonresidents

The U.S. uses as a worldwide taxation system, which means that U.S. citizens and residents are subject to U.S. income tax on their worldwide income. This is dramatically different than most countries, which use a territorial system to impose income tax only on the income generated within that country's own borders. To offset potential double taxation, the U.S. allows taxpayers to use worldwide expenses to reduce worldwide income, and grants a foreign tax credit for foreign income taxes paid on income generated outside of the United States.

Because of the dramatic differences between worldwide taxation for U.S. purposes, and the territorial taxation system that a nonresident may be accustomed to, nonresidents must know how and when they will be treated as residents for U.S. tax purposes. For income tax purposes, non-citizens are divided into two groups: residents and nonresidents. An income tax resident is a person who satisfies one of two tests: the legal permanent resident test and the Substantial Presence Test.

- The legal permanent resident test (also known as the "green card test") is satisfied if a person is a lawful permanent resident of the United States (because they have been granted a "green card," and with it, the right to legally reside in the United States) at any point during the tax year.
- The Substantial Presence Test, although more complicated, is satisfied if a person is present in the United States for at least 31 days during the calendar year, and for 183 or more total days during the current year and the previous two years (with only a fraction of each day from the prior two tax years being counted). A person who can demonstrate a closer connection to another country can qualify for an exemption to the Substantial Presence Test.

Both of these objective tests produce a clear result based on bright-line rules. Once determined to be a resident under either test, residents must file income tax returns to report and pay tax on their worldwide income.

A. Income Tax Resident

An individual is a U.S. resident for income tax purposes by being a citizen,[1] being a lawfully admitted permanent resident of the United States

[1] Code § 7701(a)(30). All citations in this outline to "Section" or "§" refer to the Internal Revenue Code of 1986, as amended (the "Code") and the applicable Treasury Regulations.

(i.e., a green-card holder),[2] meeting the "Substantial Presence Test" by spending a certain number of days in the United States,[3] or by making a first year election to be treated as a resident alien.[4]

Citizen. A citizen of the United States is a resident for income tax purposes. This rule applies even if the taxpayer is not living or has not lived in the United States.

Permanent Resident. A "lawful permanent resident" is treated as a resident of the United States for income tax purposes.[5] A "lawful permanent resident" is defined as alien individual who has been lawfully "awfully accorded the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws" (i.e., the person has received a green-card from the U.S. Citizenship and Immigration Services)[6] and that status has not been revoked[7]. is treated as a resident of the United States with respect to any calendar year.[8]

An individual will not be treated as a lawful permanent resident if he or she is treated as a resident of another country under a tax treaty between, does not waive the benefits of that tax treaty, and notifies the IRS about this treatment.[9]

The Substantial Presence Test. Under the Substantial Presence Test, a foreign citizen may be taxed as a U.S. resident by being physically present in the United States for at least 31 days in the current year, and an aggregate of 183 days in the current year and the two previous years. For this purpose, current year days are given full weight, days from the immediately prior year are given one-third weight, and days from the second prior year are given one-sixth weight. For example, if a person spent 32 days in the United States in 2015, 120 days in 2014, and 360 days in 2013, his total days for 2015 would be 32 + 120/3 + 360/6 = 132 days.[10]

Note that a person will never violate this second rule by spending no more than 121 days in the United States in any year (121 + 121/3 + 121/6 = 181.5 days).

In general, an individual is treated as present in the United States on any day if such individual is physically present in the United States at any time during such day.[11] Thus, if a person flies into the United States before midnight on a day, he is considered to be present in the United States on that day. There are a few relevant exceptions to this rule. If an individual is in transit between two points outside the United States and is physically present in the United States for less than 24 hours, the individual is not treated as present in the United States on any day during such transit.[12] For example, if a person lands in Miami and flies out to Jamaica within 24 hours of landing, he is not considered to be present in the United States at any point during his stay.

An individual will not be considered present on any day that the individual intends to leave and is unable to leave the United States because of a medical condition or medical problem that arose while the individual was present in the United States. A day of presence will not be excluded if the individual, who was initially prevented from leaving, is subsequently able to leave the United States and then remains in the United States beyond a reasonable period for making arrangements to leave the United States. A day will also not be excluded if the medical condition arose during a prior stay in the United States (whether or not days of presence during the prior stay were excluded) and the alien returns to the United States for treatment of the medical condition or medical problem that arose during the prior stay.[13]

[2] Code § 7701(b)(1)(A)(i).
[3] Code § 7701(b)(1)(A)(ii).
[4] Code § 7701(b)(1)(A)(iii).
[5] Code § 7701(b)(1)(A)(i).
[6] Code § 7701(b)(6)(A).
[7] Code § 7701(b)(6)(B).
[8] Code § 7701(b).
[9] Code § 7701(b)(6).
[10] Code § 7701(b)(1)(A)(ii).
[11] Code § 7701(b)(7).
[12] Code § 7701(b)(7)(C).
[13] Treas. Reg. § 301.7701(b)-3(c).

Whether an individual intends to leave the United States on a particular day will be determined based on all the facts and circumstances. Thus, if at the time an individual's medical condition or medical problem arose, the individual was present in the United States for a definite purpose, which by its nature could be accomplished within the United States during a period of time that would not cause the individual to be a resident under the Substantial Presence Test, the individual may be able to establish that he or she intended to leave the United States. However, if the individual's purpose is of such a nature that an extended period of time would be required for its accomplishment (sufficient to cause the individual to be a resident under the Substantial Presence Test), the individual would not be able to establish the requisite intent to leave the United States. If the individual is present in the United States for no particular purpose or a purpose by its nature that does not require a specific period of time to accomplish, the determination of whether the individual has the requisite intent to leave the United States will depend on all the surrounding facts and circumstances. In the case of an individual adjudicated mentally incompetent, proof of intent to leave the United States may be determined by analyzing the incompetent's pattern of behavior prior to the adjudication of incompetence. Generally, an individual will be presumed to have intended to leave during a period of illness if the individual leaves the United States within a reasonable period of time (time to make arrangements to leave) after becoming physically able to leave.

A medical condition or problem will not be considered to arise while the individual is present in the United States if the condition or problem existed before the individual's arrival in the United States and the individual was aware of the condition or problem, regardless of whether the individual required treatment for the condition or problem when the individual entered the United States.

For example, assume that a person enters the United States on a business trip on March 1 with a return plane ticket for March 8. If a person becomes ill on March 7 and is unable to leave the United States until March 20, the days he spent in the United States from March 9 through March 20 should not count for the day counting rules. The days from March 1 through March 8 would count, because he intended to remain in the United States on those days (as per his plane ticket).

An individual must file IRS Form 8843 to exclude any days on account of a medical condition.

Closer Connection. As discussed above, the most conservative approach is to never spend more than 121 days in the United States in any year. However, if an individual exceeds 121 days in the United States in a year, he may find that he fails the Substantial Presence Test. For example, if a person spends 120 days in the United States in 2013, 210 days in 2014, and 100 days in 2015, his total days will be 190 (120/6 + 210/3 + 100 =190). In that case, he may wish to avail himself of an exception to the Substantial Presence Test if he has a "closer connection" with a foreign country.[14] The closer connection test is only available for a year in which he spends fewer than 183 days in the United States. If he spends 183 days or more in the United States during the year, the closer connection exception is not available.

To qualify, the individual must establish that he has a tax home in a foreign country and that he has a closer connection to such foreign country than to the United States. An alien individual who has personally applied, or taken other affirmative steps, to change his or her status to that of a permanent resident during the current year or has an application pending for adjustment of status during the current year will not be eligible for the closer connection exception.

An alien individual will be considered to have a closer connection to a foreign country than the United States if the individual establishes that the individual has maintained more significant contacts with the foreign country than with the

[14] Code § 7701(b)(3)(B).

United States. In determining whether an individual has maintained more significant contacts with a foreign country than the United States, the facts and circumstances to be considered include the following:

- The location of the individual's permanent home
- The location of the individual's family
- The location of personal belongings, such as automobiles, furniture, clothing and jewelry owned by the individual and his or her family
- The location of social, political, cultural or religious organizations with which the individual has a current relationship
- The location where the individual conducts his or her routine personal banking activities
- The location where the individual conducts business activities (other than those that constitute the individual's tax home)
- The location of the jurisdiction in which the individual holds a driver's license
- The location of the jurisdiction in which the individual votes
- The country of residence designated by the individual on forms and documents
- The types of official forms and documents filed by the individual, such as Form 1078 (Certificate of Alien Claiming Residence in the United States), Form W-8 (Certificate of Foreign Status) or Form W-9 (Payer's Request for Taxpayer Identification Number).[15]

A taxpayer must file IRS Form 8840 for the applicable year to use the closer connection exception. The Form 8840 is filed with Internal Revenue Service Center, Austin, TX 73301-0125 (or with the person's U.S. tax return, if he files one). This form should be filed by April 15 of the year following the tax year for which the closer connection exception is claimed. Form 8840 requires the person to enter the number of days that he was present in the United States for the year of filing and the previous two years.

[15] Treas. Reg. § 301.7701(b)-2(d)(1).

Some commentators have indicated that the IRS will accept a Form 8840 even without an individual taxpayer identification number, or ITIN. (The ITIN is an identification number used by certain non-citizens when dealing with the IRS) Indeed, these commentators opine that if an individual filed a Form 8840 with an ITIN application attached, the IRS may reject the ITIN application.

A person loses the right to claim the closer connection exception if Form 8840 is not filed on a timely basis.[16]

Special Rules for Students. An "exempt individual" may exclude his days of presence in the U.S. for purposes of the day counting rules described above. For this purpose, an "exempt individual" includes a student. A student is defined to include an alien who is temporarily present in the United States on an F-visa or on an M-visa or as a student on a J-visa or a Q-visa. Furthermore, the student must be in substantial compliance with the requirements of his visa.[17] A student will be in substantial compliance with his visa requirements if he has not engaged in activities prohibited under the immigration laws that could result in a loss of visa status.[18]

An individual cannot exclude days of presence in the United States as a student if the person has been exempt as a student for any part of more than five calendar years. This five-year period may be extended in certain circumstances.[19]

An immediate family member of a student (generally, his spouse and minor children) will also qualify for the student exemption if their visa status is derived from and dependent on the student's visa status as a student.[20]

An individual must file a Form 8843 to establish his eligibility for the student exception to the Substantial Presence Test.

[16] Treas. Reg. § 301.7701(b)-8(d).
[17] Code § 7701(b)(5)(D).
[18] Treas. Reg. § 301.7701(b)-3(b)(6).
[19] Code § 7701(b)(5)(E)(ii).
[20] Treas. Reg. § 301.7701(b)-3(b)(8).

B. Income Taxation

Individuals who are nonresident aliens of the U.S. for income tax purposes are only subject to U.S. income tax on items of income that are derived from sources within the U.S.[21] Unlike citizens and residents, nonresidents are only subject to income tax on income derived from sources within the U.S. Instead of a single set of tax rules applicable to all income, the income derived by a nonresident is subject to four broad categories of taxation.

- Effectively Connected Income ("ECI")—Income from U.S. sources that is "effectively connected" with a U.S. trade or business is taxed at graduated rates on a net basis. Income is generally treated as effectively connected with a U.S. trade or business if the taxpayer is engaged in a business located in the U.S., and the "effectively connected" income is generated by that business.
- Fixed, Determinable, Annual, or Periodical Income ("FDAP" Income)—FDAP Income is generally defined as all income other than gains derived from the sale of real or personal property, and certain items excluded from gross income. But any FDAP Income that is not "effectively connected" with a U.S. trade or business (e.g., dividends, interest, and royalties) is taxed at a flat 30% rate. A significant drawback to being taxed at a flat rate is that a taxpayer is taxed on the gross amount received, and is not allowed deductions for the expenses of producing such income.
- Sales of U.S. Real Property and the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA" Income)—A nonresident's disposition of a U.S. real property interest is treated as effectively connected with a U.S. trade or business, and is subject to mandatory tax withholding at 10% or 15% rates, depending on the taxpayer.
- Income Not Subject to Income Tax—A few types of income, such as interest generated by assets held in a bank account, escape income tax entirely.

Where an individual performs services determines the source of compensation income, not the currency of payment or the location of an employer. Investment income arising from U.S. sources is subject to tax at flat rates. Limited expenses and credits are allowed to reduce taxable income. Generally there are no deductions allowed for family members (spouse and dependents). Applicable U.S. income tax treaties may provide for a reduced rate of U.S. income tax or an exemption from U.S. income tax for certain items of income.

C. Effectively Connected Income

A foreign taxpayer is taxable at regular graduated tax rates on his, her or its net income that is effectively connected with a U.S. trade or business or from the performance of personal services in the U.S. This effectively connected income is sometimes called "ECI".[22] The determination of whether income is effective connected with a U.S. trade or business is a two-prong test. Under the first prong, the taxpayer must be engaged in a U.S. trade or business, while under the second prong, any income must be effectively connected with such U.S. trade or business. Income from fixed or determinable sources within the United States (dividends, interest, royalties, and the like) is taxed at flat 30% rates (or reduced treaty rates) by the payor withholding upon each periodic payment. Income from the sale or exchange of capital assets located in the United States other than real estate is subjected to tax at the same 30% rate, but only if the recipient was present in the United States for more than 182 days both in the year the taxable gain was effected and in the year the income was collected (if it is a later year). These provisions may be affected by treaties with the nonresident's domicile country.

[21] Code §§ 861-884.

[22] Code § 871(b) A tax treaty may, however, provide that residents of the treaty country are not subject to taxation of income from a U.S. trade or business unless the taxpayer has a permanent establishment in the U.S.

It is possible for a nonresident alien to have both effectively connected income and non-effectively connected income in the same year. If the nonresident alien has both, the filing of a return will almost always be required. If the nonresident alien only had non-effectively connected income and income tax is withheld at the source, no return would likely need to be filed.

Income Connected with the Conduct of a Trade or Business. Income from a U.S. trade or business, which is taxed at graduated rates, is generally of one of three kinds: personal services, trading in securities or commodities, and other types of income as determined based upon the facts and circumstances under which the income is earned.[23]

Personal Services. A nonresident alien individual's income from the conduct of a U.S. trade or business includes income from the performance of personal services within the U.S. at any time during the tax year. However, if the services are performed for a foreign employer, the aggregate compensation does not exceed $3,000 and the nonresident alien employee is present in the U.S. for 90 days or less during the tax year, the nonresident alien individual will not be treated as being engaged in a U.S. trade or business.[24]

Trading in Securities or Commodities. A foreign person who trades in stocks, securities, or commodities in the U.S. is not treated as conducting a U.S. trade or business (and is not subject to U.S. income tax on his or her "effectively connected income" from the securities or commodities trading) if the foreign person does not have an office in the U.S. through which, or under the direction of which, the securities transactions are affected.[25] Safe harbor rules enabling a foreign individual, corporation, or trust to avoid being treated as conducting a U.S. trade or business even if he or she or it has an office in the U.S. that otherwise would cause them such income to be effectively connected income if the transactions are for the taxpayer's own account.[26]

Facts and Circumstances Test. Activities of the taxpayer, other than performing personal services and trading in securities and commodities may also be classified as ECI based on the facts and circumstances (the IRS will not provide determination letters with respect to the classification of such income).[27] This test examines the nature and extent of the taxpayer's contacts with the U.S. and the economic activities themselves. A U.S. trade or business does not include isolated and nonrecurring transactions unless there is a profit motive (such as the sale of an asset held for investment). The taxpayer must, during some substantial portion of the tax year, have been regularly and continuously transacting business in the U.S.

Whether a foreign corporation is engaged in a U.S. trade or business depends on the facts and circumstances of each case. In Revenue Ruling 88-3, the Internal Revenue Service wrote that the inquiry is "highly factual." The determination is based on the nature and extent of the corporation's economic activities in the U.S. (either directly or through an agent). A U.S. trade or business exists if these activities are "considerable, continuous and regular."[28] As one commentator has noted, the test has both qualitative and quantitative elements.[29] Whether a foreign corporation is engaged in a U.S. trade or business depends on the nature of the activities and the extent of the activities.

To constitute a U.S. trade or business, the foreign taxpayer's activities in the U.S. must be active. More than a passive investment or

[23] Code § 872(a).
[24] Code § 861(a)(3).
[25] Code § 864(b)(2).

[26] Code §§ 864(b)(2)(A)(ii), (B)(ii).
[27] Code § 864(b)(2).
[28] *Pinchot v. Comm'r*, 113 F2d 718, 719 (2d Cir. 1940); *de Amodio v. Comm'r*, 34 T.C. 894, 906 (1960), aff'd 299 F2d 623 (1962); *Spermacet Whaling & Shipping Co. v. Comm'r*, 30 T.C. 618, 634 (1958), aff'd 281 F2d 646 (6th Cir. 1960).
[29] Katz and Plamlock, 908 T.M. A-13, *U.S. Income Taxation of Foreign Corporation*, A-13.

ownership of property is necessary.[30] In addition to being active, the foreign corporation's activities must be of a type that are closely and directly related to the profit-making activity and not merely incidental, ministerial or clerical.[31]

The activities of an agent can be imputed to a foreign corporation in some situations. If these activities constitute a U.S. trade or business, they will cause the foreign corporation to be treated as engaged in a U.S. trade or business.[32] The tax law makes a distinction between dependent and independent agents. The activities of dependent agents are almost always imputed to the foreign principal. The activities of an independent agent are imputed to the foreign principal on a much more limited basis.[33] There is not a clear definition of whether an agent is an independent or dependent agent. In the context of a tax treaty, the U.S. Tax Court has written that an independent agent is one who is legally independent and economically independent of the principal.[34] An agent is legally independent if the agent has reasonable discretion as to the manner in which it is to provide its services and is not restricted to providing those services only to one principal. In contrast, a dependent agent is one whose activities are more closely regulated by the principal. An agent is economically independent if the agent is not guaranteed a certain income regardless of the success of the business. An agent is economically independent to the extent that it has a risk of loss or not getting compensated if the venture fails. For example, a commission based sales person is an independent agent to the extent that he or she only receives compensation upon making sales.

Where a partnership is engaged in a U.S. trade or business, nonresident alien individuals and foreign corporations who are partners of the partnership will be treated as engaged in a U.S. trade or business.[35]

The second prong of the test is to determine whether the income is *effectively connected* with such U.S. trade or business. The test is applied on annual basis. If a taxpayer is engaged in a U.S. trade or business, all its U.S. source income is treated as effectively connected with the business, under what is sometimes called the "force of attraction" principle.[36] An exception to the force of attraction rule applies to fixed or determinable annual or periodical gains, profits and income ("FDAP")[37] or capital gains that do not run afoul of either the "asset use test" or the "business activities test."[38] Under the asset use test, capital gains or FDAP income are effectively connected if they are derived from *assets* used or held for use in the conduct of the

[30] *See e.g. Continental Trading. Inc. v. Comm'r*, 265 F2d 40, 43 (9th Cir. 1959), cert. denied, 371 U.S. 827 (1959); *Neill v. Comm'r,* 46 B.T.A. 197 (1942), (foreign individual not engaged in a U.S. trade or business where he owned and leased a U.S. building on a triple net lease basis under which the tenant was responsible for the day-to-day activities of maintaining the building.)

[31] *Scottish American Investment Co. v. Comm'r, 12 T.C. 49 (1949).*

[32] *Lewenhaupt v. Comm'r*, 20 T.C. 151 (1953) (taxpayer was engaged in a trade or business where, through his agent, he executed leases, rented property, collected rents, kept books of accounts, supervised repairs, paid taxes and mortgage interest, insured property, and purchased and sold property).

[33] *De Amodio v. Comm'r*, 34 T.C. 894, 906 (1960), aff'd 299 F2d 623 (1962) (purchase and management of real estate by independent real estate agents on behalf of a foreign taxpayer caused the taxpayer to be engaged in a U.S. trade or business); *compare Amalgamated Dental Co. v. Comm'r,* 7 T.C. 1009 (1946), (foreign corporation received orders from U.S. customers and a U.S. supplier filled the customer orders and billed the customer for these products; actions of the U.S. supplier could not be imputed to the foreign corporation.)

[34] *Taisei Fire and Marine Insurance Corp., Ltd. v. Comm'r*, 104 T.C. 535 (1995).

[35] Code § 875(1).

[36] Code § 864(c)(3).

[37] Fixed or determinable annual or periodical income is a term of used by the Code to describe certain types of recurring income types, such as dividends, rents, interests, that (generally) are not effectively connected with a U.S. trade or business. Code § 871(a).

[38] Code § 864(c)(3).

foreign person's U.S. trade or business.[39] Under the business activities test, capital gain or FDAP income is effectively connected if it is derived from *activities* of the foreign person's U.S. trade or business that are a material factor in the realization of gain or income.[40]

For example, consider the case of a foreign corporation that is engaged in the business of selling jazz records in the United States through a U.S. branch. The corporation also sells medical diagnostic equipment through its home office in France. Most of the corporation's sales of medical equipment are to European customers, but it occasionally sells to U.S. customers as well. The corporation's U.S. branch does not participate at all in the medical equipment business. The corporation also recognizes gain from the sale of Exxon stock held as a portfolio investment.

Under the general source rules applicable to inventory, a sale of inventory is generally considered U.S. source income if title passes in the United States. Thus, the corporation's U.S. source income from selling jazz records in the United States is effectively connected with a U.S. trade or business. Moreover, under the "force of attraction" principle, the corporation's U.S. source income from selling medical equipment in the United States is also treated as effectively connected income, even though the corporation is not in a business of selling medical equipment in the United States. The corporation's gain from the sale of the Exxon stock is probably not effectively connected income, as it is not derived from assets used in a U.S. business and the corporation's U.S. activities were not a material factor in the recognition of the gain.

A foreign taxpayer's foreign source income may also constitute effectively connected income if the foreign taxpayer has an office or other fixed place of business within the United States to which the income is attributable and the income is one of the following:

- Rents or royalties for the use of or for the privilege of using certain intangible property derived in the active conduct of a trade or business.[41]
- Dividends or interest, and either is derived in the active conduct of a banking, financing, or similar business within the United States or is received by a corporation the principal business of which is trading in stocks or securities for its own account.[42]
- Derived from the sale or exchange outside the United States though the office or other fixed place of business of inventory property (not including inventory property sold or exchanged for use, consumption, or disposition outside the United States where an office or other fixed place of business of the taxpayer in a foreign country participated materially in the sale.).[43]

D. Fixed Or Determinable Annual Or Periodic Income ("FDAP") Income

A foreign taxpayer is subject to a tax at a flat rate of 30% on its fixed or determinable annual or periodic income, or "FDAP" income.[44] The 30% tax applies if the taxpayer is not engaged in a U.S. trade or business, or if the taxpayer is engaged in a U.S. trade or business, the income in question is not effectively connected with that trade or business. The flat 30% tax is also imposed on original issue discount on certain debt obligations,[45] net gains from the sale of capital assets of taxpayers who have been present in the United States for 183 days or more during the taxable year[46] and 85% of any social

[39] Treas. Reg § 1.864-4(c)(2)(ii).
[40] Treas. Reg § 1.864-4(c)(3).

[41] Code § 864(c)(4)(B)(i).
[42] Code § 864(c)(4)(B)(ii).
[43] Code § 864(c)(4)(B)(iii).
[44] Code § 871(a)(1); Code § 881(a)(1).
[45] Code § 871(a)(1)(C). Original issue discount accrues over the life of the debt instrument under rules in Code § 1273. Nonresidents are taxed on accrued OID when payments are made on the instrument, or when an OID obligation is sold or exchanged.
[46] Code § 871(a)(2). Note that in most cases, a person who is present in the United States for more than 183 days during a taxable year is treated as a resident for

security benefits.[47] A significant drawback to taxation under this regime is that a taxpayer is not allowed any deduction for the expenses of producing such income. In many instances, as discussed below, this effect is ameliorated by an applicable tax treaty that provides for lower tax rates for dividends, interest, or other types of FDAP.

Certain types of income are not subject to the 30% tax. A foreign taxpayer is not subject to U.S. tax on U.S. source capital gain not effectively connected with a U.S. trade or business. Interest on bank deposits with U.S. banks paid to nonresident aliens or foreign corporations is not taxed in the United States if the interest is not effectively connected with the foreign person's U.S. trade or business.[48] Also excepted is "portfolio interest", which is interest paid to foreign persons on certain debt obligations in registered form or on bearer debt obligations where the debt obligation is targeted to a foreign market and the interest on the obligation is payable only outside the United States.[49] The portfolio interest exception does not apply to (i) interest payments to foreign individuals or entities owning at least 10% of the voting power in the U.S. corporation or partnership[50], (ii) interests received by a controlled foreign corporation from a related person[51], or (iii) contingent interest where the amount of such interest is determined by reference to (a) any receipts, sales or cash flow of the debtor or a related person, (b) any income or profits of the debtor or a related person, (c) any change in value of any property of the debtor or a related person, or (d) any dividend, partnership distributions or similar payments made by the debtor or a related person.[52] The portfolio interest exception will also not apply to bank loans made in the ordinary course of business.

Finally, the 30% tax does not apply to a proportionate amount of a dividend paid by a domestic corporation that derives 80% or more of its income from an active foreign business in the three-year period before the year in which it pays a dividend.[53]

E. Real Property & FIRPTA

Although foreign taxpayers are generally not taxed on capital gains located are treated is located in the past, there is an exception for real property. Before the enactment of the Foreign Investment in Real Property Tax Act ("FIRPTA") in 1980, a foreign person could invest in US real property without being subject to U.S. income tax on the later sale or disposition of that U.S. real property, providing a great advantage to foreign investors. FIRPTA added Code § 897, which treats a foreign individual or foreign corporation's gain and loss from the disposition of a U.S. real property interest, or "USRPI", as income or loss effectively connected with a U.S. trade or business. As a result, the rules for real property follow the general rules of taxation for income derived by a foreign person: the income is subject to U.S. income tax either on a gross basis with no deductions for income that is not effectively connected income or on a net basis if it is effectively connected income.

A USRPI under FIRPTA includes the following:

- Real property and any natural products of the land, improvements and personal property associated with the use of real property.[54]
- An interest in a domestic corporation if the corporation was a U.S. Real Property

U.S. federal income tax purposes, and would thus be subject to tax at graduated rates on his worldwide income. Thus, the scope of the rule under Code § 871(a)(2) is narrow. However, certain persons, including students and foreign government officials, may avoid U.S. resident status even if present in the United States for more than 183 days in a year. Such persons would thus be subject to the Code § 871(a)(2) regime.

47 Code § 871(a)(4).

48 Code §§ 871(i)(2)(A), 881(d).

49 Code §§ 871(h), 881(c).

50 Code §§ 871(h)(3), 881(c)(3)(B).

51 Code § 881(c)(3)(C).

52 Gustafson, Peroni and Pugh, *Taxation of International Transactions*, ¶4040, p. 204.

53 Code § 871(i)(2)(B).

54 Code § 897(c)(1)(A)(i).

Holding Company ("USRPHC") during the five-year period ending on the date of the disposition of the interest in the corporation.[55] A USRPHC is a corporation that owns USRPIs the value of which comprises 50% or more of the aggregate value of all its assets.[56]

- An interest in domestic and foreign partnership interest, trusts, or estate attributable to USRPIs. Code § 897(g) states that, under regulations prescribed by the Secretary, the amount of any money, and the fair market value of any property, received by a nonresident alien individual or foreign corporation in exchange for all or parts of its interest in such entity shall, to the extent attributable to USRPIs, be treated as a USRPI. Although only regulations for partnerships have been issued, the Service takes the position that Code § 897(g) also applies with respect to interests in trusts and estates.[57]

A USRPI does not include the following:

- An interest in a corporation if (a) as of the date of the disposition of such interest, such corporation did not hold any USRPI, (b) all of the USRPI held by such corporation at any time during the shorter of (1) the period during which such taxpayer held such interest, or (2) the five-year period ending on the date of the disposition of such interest, were disposed of in transactions in which the full amount of the gain (if any) was recognized, and (c) neither the corporation nor any predecessor corporation was a regulated investment company or a REIT at any time during that period.[58] This exclusion of corporations which have disposed of all their USRPI is also referred to as the "purging rule" or the "cleansing exception."
- An interest solely as a creditor with respect to a USRPI. If a loan gives the holder an interest in the appreciation of the underlying USRPI, then the creditor interest is treated as a USRPI.[59]
- An interest in a foreign corporation.[60] Instead, tax is imposed on the foreign corporation's disposition or distribution of the real property interest. Tax treaties and nonrecognition provisions cannot be utilized to avoid the tax inherent in the real property owned by a foreign corporation. A purchaser of stock in a foreign corporation with USRPI will assume the U.S. tax liability inherent in the U.S. real property, which typically reduces the purchase price of the shares.

Withholding Requirement. Generally, the transferee of a foreign person's USRPI must withhold 15% of the purchase price (not the gain on the sale) on the disposition of the USRPI.[61] The transferee must then send that 15% withheld tax to the IRS no later than the 20th day after the date of the transfer.[62] This withholding may not be the actual amount of tax due on the disposition, and is only an advance payment toward the final U.S. income tax obligation. So, the foreign investor will need to file the appropriate income tax return (e.g., Form 1040NR and Form 1120F) to report the sale by the appropriate deadline. Any tax withheld on the sale will be credited against the amount of tax due on the return.[63]

There are several exemptions to this withholding. If the purchaser acquires the property to use as a residence and the amount realized does not exceed $300,000, then no withholding is required.[64] If the seller provides the purchaser with an affidavit stating, under penalty of perjury, the seller's United States taxpayer identification number and that the seller is not a foreign person, then no withholding is required.[65] If the interest

[55] Code § 897(c)(1)(A)(ii).
[56] Code § 897(c)(2).
[57] Code § 897(c)(4).
[58] Code § 897(c)(1)(B)(i).
[59] Code § 897(c)(1)(A)(ii).
[60] Code § 897(c)(4).
[61] Code § 1445(a).
[62] Treas. Reg. § 1.1445-1(c)(1).
[63] Treas. Reg. § 1.1445-1(f)(1).
[64] Code § 1445(b)(5).
[65] Code § 1445(b)(2).

transferred is a share of a class of stock that is regularly traded on an established securities market, then no withholding is required.[66]

PATH Act Changes. Signed on December 18, 2015, the Protecting Americans From Tax Hikes Act of 2015 ("PATH Act") made significant changes to FIRPTA. For example, before the PATH Act, a nonresident owning 5% or less of a publicly traded U.S. real estate investment trust ("REIT"), would not be subject to FIRPTA. The PATH Act has increased this percentage to 10%, which increases the ability of nonresidents to invest in the US without being subject to US income tax. This change is meant to align the Code with current tax treaties. Distributions from a REIT remain subject to 30% withholding.

The PATH Act has increased withholding on the disposition of a USRPI from 10% to 15% of the purchase price (not the gain on the sale). But the withholding rate will remain 10% if the purchase price is less than $1,000,000 and the property is acquired for use as a residence.[67]

F. Income Tax Treaties

Foreign taxpayers making investments in the United States often hail from countries with which the U.S. has bilateral income tax treaties. These tax treaties may modify the applicability of the statutory rules described above to avoid inappropriate double taxation between the US and the treaty partner that may occur when both countries attempt to tax the same income. For example, while the FDAP income of a foreign taxpayer not engaged in a U.S. trade or business is subject to a 30% flat withholding tax under the Code, an applicable tax treaty may impose a lesser tax rate of 5% or 15%, or even be exempt the income from taxation altogether. The availability of a benefit under a tax treaty will not alter the tax results of any other transaction that the treaty does not cover. For example, if a person is required to report information as either a resident or a non-resident, the provisions of a tax treaty will not alter that requirement unless the treaty specifically provides for that exemption.

Because each treaty is negotiated separately, the provisions in one treaty will not necessarily be identical in another treaty.

Residence. The benefits of a U.S. tax treaty are generally limited to residents of the treaty country. As a very general matter, a taxpayer is a treaty country resident if the taxpayer is liable to taxation on the basis of a personal connection with the taxing jurisdiction. In this respect, whether a person is a "resident" of a treaty country turns on the local law of the treaty country. If a person is a resident of both the treaty country and the United States, the treaty may contain a so-called "tie-breaker" provision.[68]

The residence of a corporation is determined in some treaties by reference to corporation's place of incorporation, and in some treaties by reference to the country where the corporation is managed.[69] Where a corporation is a resident

[66] Code § 1445(b)(6).

[67] Code § 1445(c)(4), Treas. Reg. § 1.1445-1(b).

[68] See e.g. Art. 4(2) of the United States-Canada Income Tax Treaty: "Where…an individual is a resident of both Contracting States, then his status shall be determined as follows:

(a) He shall be deemed to be a resident of the Contracting State in which he has a permanent home available to him; if he has a permanent home available to him in both States or in neither State, he shall be deemed to be a resident of the Contracting State with which his personal and economic relations are closer (centre of vital interests);

(b) If the Contracting State in which he has his centre of vital interests cannot be determined, he shall be deemed to be a resident of the Contracting State in which he has an habitual abode;

(c) If he has an habitual abode in both States or in neither State, he shall be deemed to be a resident of the Contracting State of which he is a citizen; and

(d) If he is a citizen of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

[69] For example, the United States-Switzerland Income Tax Treaty looks to a corporation's place of

under more than one tax treaty, the IRS generally permits the corporation to apply the more favorable treaty.[70]

Limitation on Benefits. Corporations that are incorporated in (and thus residents of) a treaty country may nevertheless be denied treaty benefits under so-called “limitation on benefits” provisions. Limitation on benefits provisions are designed to prevent “treaty shopping”, a term that connotes the use of a treaty country entity by persons who lack a real or significant connection to the treaty country in order to obtain the benefits of the treaty. In general, “limitation on benefits” provisions restrict treaty benefits to entities (1) that are owned to a sufficient degree by residents of treaty jurisdictions, and (2) that do not erode their residence country tax base through deductible payments to persons outside the treaty jurisdictions.

Some treaties contain an alternate test under which an entity that does not meet this shareholder/base erosion test may nevertheless still qualify for treaty benefits if the entity is engaged in an active trade or business in the residence country and derives income from the country connected with that business. Entities that are publicly traded on a recognized stock exchange in the treaty country may also be entitled to treaty benefits.

Trade or Business Income. Recall that under general statutory principles, the United States imposes tax on a foreign taxpayer’s business income if the income is effectively connected with a U.S. trade or business. An analogous concept under U.S. income tax treaties provides that the United States may impose tax on a foreign taxpayer’s business profits that, under the treaty, are attributable to a permanent establishment in the United States. This concept has three components:

- Does the taxpayer have a permanent establishment in the United States?
- Is the income in question “business profits”?
- Is the income attributable to the permanent establishment?

The definition of a permanent establishment (or “PE”), which is usually a fixed place of business through which the business is carried on, varies from treaty to treaty. Art. 5(2) of the U.S. Model Treaty defines a permanent establishment as a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry or any other place where natural resources are being extracted. In general, a taxpayer will have a permanent establishment if it maintains a resident agent in the United States with authority to enter into contractual relationships or who has authority to fill orders from a stock of goods located in the United States.

A foreign taxpayer will generally not have a permanent establishment by virtue of maintaining an “independent agent” in the United States, however. The fact that a foreign corporation has a U.S. subsidiary will generally not, in and of itself, cause the taxpayer to have a permanent establishment in the United States. At the same time, the subsidiary may act in such a way that it causes in foreign parent to have a U.S. permanent establishment.

The term “business profits” generally means the taxpayer’s business income. Older tax treaties use the term “industrial or commercial profits.” Under many treaties, business profits that are not attributable to a U.S. permanent establishment are not subject to U.S. tax. Thus, it can be important to distinguish business profits from other types of income from the United States (such as dividends or interest) which may be taxed in the United States under the treaty even if they would not be considered attributable to a U.S. permanent establishment. Sometimes, an

incorporation, while the United States-United Kingdom Income Tax Treaty looks to a corporation’s place of management.

[70] Rev. Rul. 73-564, 1973-2 C.B. 435 (corporation formed in Switzerland and managed in United Kingdom could choose either treaty for taxation of U.S.-source interest); *but see* Rev. Rul. 2004-76, 2004-2 C.B. 11 (corporation resident in Country X and Country Y was only a resident of Country Y where, under the tax treaty between the two countries, the corporation was treated as a Country Y resident).

item of income could be characterized as both business profits and some other type of income taxable under the treaty, such as dividends or interest. In the case of such an overlap, some treaties give priority to the treaty provisions applicable to the other type of income. For example, if a foreign taxpayer earns interest in the United States that could be considered business profits, but is not attributable to a permanent establishment, under such a treaty, the interest would be taxed under the treaty provisions applicable to interest. (If the interest is attributable to a permanent establishment, however, it is usually taxed under the treaty's business profits provision.)[71] Different tax treaties contain different specific definitions of "business profits." For example, under some treaties, an individual does not have "business profits" from the provision of services as an employee or independent contractor.[72]

Only business profits that are attributable to the taxpayer's PE are taxable under a treaty's business profits provision. As such, there must be a requisite level of connection between an item of income and the taxpayer's permanent establishment. In general, a taxpayer's income attributable to a permanent establishment is determined by treating the permanent establishment as an independent entity.[73] For example, under the United States-Canada Income Tax Treaty there are "attributed to a permanent establishment the business profits which it might be expected to make if it were a distinct and separate person engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the resident and with any other person related to the resident." Likewise, with respect to expense, the United States-Canada Income Tax Treaty provides that "in determining the business profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere."

Under many treaties, only U.S.-source business profits may be attributable to a U.S. permanent establishment.[74] In this respect, such treaties are more narrowly focused that the analogous statutory provisions, under which foreign source income may be effectively connected with a U.S. trade or business.

Investment Income. In general, U.S. tax treaties provide a lower tax rate on dividends, rents, and interest than the statutory 30% rate. Dividends are typically subject to a 15% rate, with dividends paid by a subsidiary to a parent generally subject to a 5% rate. Interest is generally not taxed or is subject to a 5% tax. Of course, the portfolio interest exemption may provide a complete exemption even if the treaty with the payee's country of residence does not fully exempt interest from withholding.

On the other hand, investment income that constitutes business profits attributable to a U.S. permanent establishment is typically taxed as business profits rather than investment income. For example, interest received on loans made by the U.S. branch of a foreign bank will generally be fully taxed as business profits, rather than subject to a lower rate of tax as interest.

2016 Updates to the U.S. Model Treaty. The Department of the Treasury has developed a Model Income Tax Treaty to use as a base for all tax treaty negotiations. On February 17, 2016, Treasury released a new U.S. Model Income Tax Treaty. These updates follow proposed changes released in 2015 that were meant to limit treaty benefits to special tax regimes that move income from the US to low-tax jurisdictions. Because these changes were made to the Model Treaty, and not to any existing tax treaties, the provisions are not yet effective for any

[71] *See e.g.*, United States-Canada Income Tax Treaty, Art. 7(6).

[72] *See e.g.*, United States-Japan Income Tax Treaty, Art. 8(5); United States-United Kingdom Income Tax Treaty, Art. 7(7).

[73] *See e.g.* United States-Japan Income Tax Treaty, Art. 8(2); United States-United Kingdom Income Tax Treaty, Art. 7(2).

[74] *See e.g.* United States-Switzerland Income Tax Treaty, Art. 3(1)(a).

transactions. But as these treaties are updated, the modified provisions will begin to appear.

G. Reporting Issues

Every nonresident alien individual who engages in a trade or business in the U.S. during the tax year (whether or not he has met taxable income), or who has any passive U.S. source income subject to U.S. income tax, must file a return (Form 1040 NR). The return must be filed with the Internal Revenue Service Center at Austin, Texas 73301-0215 (for individuals) or Cincinnati, Ohio 45999-0048 (for estates and trusts) by the 15th day of the fourth month following the end of the taxpayer's fiscal year (thus by April 15 for calendar year taxpayers) if the taxpayer had income from wages, and by the 15th day of the sixth month in all other cases. Any taxes due must be paid with the return to the extent not previously withheld by the paying agent.

An important exception to the requirement that a nonresident alien file an income tax return allows the taxpayer to avoid filing a return if all of his or her income was passive income subject to withholding at the source, and if the applicable tax was in fact fully withheld. This exception does not apply to a taxpayer with income effectively connected with the conduct of a U.S. trade or business, or with FTRPTA income, in both of which cases a return must be filed.

H. Marital Issues

For a married couple, the rules for determining residency must be applied to both spouses. It is possible that, for example, a person's wife might be a U.S. resident for income tax purposes even if he is treated as a nonresident.

A spouse who is a U.S. resident for income tax purposes will generally be taxed on her worldwide income for the taxable year (that is, her income from in and out of the United States). In determining her taxable income, the role of the community property laws must be considered. In general, the community property system is a system of martial property rights under which property acquired during a marriage is treated as jointly owned by both spouses. Similarly, income earned during marriage is deemed to belong to both spouses. Several U.S. states, including Texas, use the community property system. The IRS has indicated that the community property system is generally in force in Mexico, subject to the spouses' articles of marriage or the agreement of the spouses during the marriage.[75]

In the case of a married couple one or both of whom are nonresident alien individuals and who have community income for the tax year, the community income is taxable as follows:

- earned income (other than trade, business or partnership) is treated as the income of the spouse who rendered the services;
- trade or business income and all the deductions attributable to that income treated as the income of the husband, unless the wife exercises substantially all of the management and control of the business, in which case the income is treated as the wife's;
- partnership distributive share income is attributed to the spouse who is in fact a partner; and
- income derived from the separate property of one spouse (as determined by the applicable community property law) is attributed to that spouse.

For all other income, the community property rules of the taxpayer's "domicile" will apply.[76] For this purpose, a taxpayer's "domicile" is a permanent legal home that the taxpayer intends to use for an indefinite or unlimited period, and to which, when absent, taxpayer intends to return.[77]

Joint Filing. A "mixed marriage" couple can elect to file a joint return if both spouses agree to

[75] Rev. Rul. 65-37, 1965-1 CB 514.
[76] Treas. Reg. § 1.879-1(a).
[77] See e.g. *Crespi v. Comm'r.*, 44 BTA 670 (1941). This is similar to the definition of residency for estate tax purposes discussed below.

be taxed on their worldwide income.[78] The election continues to apply in subsequent years until it is suspended or terminated. If the taxpayers revoke the election they cannot again make the election. The regulations require a joint return for the year the election is first made, but the spouses may file either joint or separate returns in later years. The election does not affect the domicile of the nonresident alien spouse for estate and gift tax purposes. There also is a provision regarding the situation where the non-U.S. spouse becomes a citizen or resident during the year. Such a couple can elect to treat the "converted" spouse as a U.S. person for the entire year.

III. Income Taxation of Trusts and Estates

The flexibility inherent in the modern trust lends itself to a variety of uses, such as property management, creditor protection, estate planning and probate avoidance. Trusts can be created upon the agreement of one or more people (the trustee) to manage another's property (the grantor) (i.e., a "lifetime" or "inter vivos" trust), or upon the death of a person whose will provides for the creation of a trust (i.e., a testamentary trust). Because states generally do not require any filing prior to the creation of a trust, statistics regarding trusts are hard to come by. However, IRS filing data can provide some insight. For 2014, the IRS received about 3.2 million estate and trust income tax returns (Form 1041).

A. *Other Types of Trusts, generally.*

Grantor Trusts. Grantor trusts are trusts which, for income tax purposes, are treated as (partially or wholly) owned by an individual.[79] As a result, some or all of the income of the trust is reportable on that individual's income tax return. Certain powers that are retained by a grantor (or, in certain instances, another person), or certain characteristics may cause such tax treatment, such as:

- Retention of a reversionary interest by the grantor or the grantor's spouse (Section[80] 673);
- The power of the grantor, the grantor's spouse, or a non-adverse to control the beneficial enjoyment of any portion of the trust (Code § 674);
- Certain administrative powers, such as the power to borrow trust funds without adequate security or interest, or the power to substitute trust assets with other property of an equivalent value (Code § 675);
- The power of the grantor or a non-adverse party to revoke the trust (Code § 676);
- The accumulation or distribution of income for the benefit of the grantor or the grantor's spouse (Code § 677);
- The power of the grantor or any other person to vest trust income or principal in him or herself (Code § 678); and
- The transfer of property by a U.S. person to a foreign trust with U.S. beneficiaries (Code § 679).

Business Trusts. Prior to the enactment of "permissive" corporate laws in the early twentieth century, the formation of a corporation typically required an act of the state legislature. As a result, many businesses at the time, such as Standard Oil, were formed as a trust. Today, the formation of a corporation, limited partnership, or limited liability company requires filling out a form and paying a filing fee and can be accomplished in about a day, reducing the use of the trust as a business entity. However, if the beneficiaries of a trust are more akin to business associates, it is still possible for a trust to be considered a "device to carry on a profit-making business", and therefore subject to tax as a partnership or corporation.[81]

Qualified Subchapter S Trusts (QSSTs). QSSTs are trusts that are allowed to be a

[78] Code § 6013(g)
[79] Code § 671.
[80] All references in this paper to the "Code" and "Section" are to the Internal Revenue Code of 1986, as amended.
[81] Treas. Reg. § 301.7701-4(b); Morrissey v. Commissioner, 296 U.S. 344 (1935).

shareholder in an S-corporation without causing the corporation to forfeit its Subchapter S status. To qualify, the trust must have only one beneficiary who is a U.S. citizen or resident, all of the trust's income must be distributed to that beneficiary, and all of the trust's assets must be distributed to that beneficiary upon death or upon termination of the trust. All income is taxed to the recipient beneficiary.[82]

Electing Small Business Trusts (ESBTs). Unlike QSSTs, ESBTs can have multiple beneficiaries, and trust income can be accumulated and/or distributed among those many beneficiaries. The income of the trust attributable to the S-corporation stock, however, is taxed at the trust level at the highest applicable tax rate.[83]

Liquidating Trusts. Liquidating trusts are typically used when winding up a business that is ceasing operations. The trust is used as a conduit to accept the assets of the failed business, convert those assets into cash, and then distribute the proceeds to the creditors of the failed business.[84]

B. *The (Non-Grantor) Trust Income Tax Rules of Subchapter J.*

Except for certain tax-exempt trusts and electing trusts included in a decedent's estate, trusts are calendar year taxpayers.[85] Gross income for a non-grantor trust is generally determined in the same manner as it is for individuals, and includes all sources of income.[86] However, in the context of trust taxation, one must be aware that "income" typically refers to fiduciary accounting income ("FAI") typically defined under state law, whereas "gross income", "taxable income", "distributable net income", etc., refers to different classifications of income for federal income tax purposes.[87] For example, under the Texas Trust Code, capital gains realized on the sale of real estate by a trust would be generally classified as principal, subject to the terms of the trust agreement and subject to the trustee's power to make adjustments.[88] However, those same capital gains are included in gross income for income tax purposes. Although the actuarial definition of "income" may not affect the definition of "gross income" for federal income tax purposes, it could have an effect on whether some or all of the capital gain is classified as "distributable net income" (discussed below).[89]

Compressed Tax Brackets. Trusts are subject to significantly compressed tax brackets compared to those of individuals or corporations. As shown below, in 2017 the highest rate of tax (not inclusive of the net investment income tax, discussed below) begins after $12,500:

2017 Taxable Income[90]	2017 Marginal Tax Rate
No greater than $2,550	15%
From $2,551 to $6,000	25%
From $6,001 to $9,150	28%
From $9,151 to $12,500	33%
Over $12,500	39.6%

Reduced Personal Exemption; No Standard Deduction. Individual taxpayers are generally entitled to a personal exemption that is adjusted for inflation (for 2017, $4,050).[91] However, trusts required to distribute all of their income annually (i.e., "simple trusts") are entitled to a personal exemption of only $300, while most other trusts (i.e., "complex trusts") can only claim a personal exemption of $100.[92] In addition, the standard deduction amount for trusts is $0.[93] However, trusts are generally entitled to claim any deductions and credits

[82] Code § 1361(c)(2).
[83] Code § 1361(e).
[84] Treas. Reg. § 301.7701-4(d).
[85] Code § 644; § 645.
[86] Code § 641(a); Treas. Reg. § 1.641(a)-2.
[87] See Treas. Reg. § 1.643(b)-1.
[88] See Tex. Trust Code § 116.161; § 116.005(a).
[89] Treas. Reg. § 1.643(a) -3(b).
[90] Code § 1(e); Rev. Proc. 2016-55.
[91] Code § 151; Rev. Proc. 2016-55.
[92] Code § 642(b)(2).
[93] Code § 63(c)(6)(C).

available to an individual.[94] Also, trusts can claim deductions for amounts paid to charities, net operating losses, depreciation, depletion and amortization.[95]

Deduction of Trust Expenses: Treas. Reg. § 1.67-4. Trustees are generally allowed to deduct trust expenses; however, deductions for costs that are "commonly or customarily" incurred by an individual managing the same property are subject to the 2% floor on miscellaneous itemized deductions.[96] Treasury has promulgated regulations following a Supreme Court decision requiring that corporate trustees "unbundle" their fee structure so that such "commonly or customarily" incurred fees are not aggregated with trustee management fees.[97] Also, the regulations provide guidance specifying that certain items are, by their nature, "commonly or customarily" incurred by an individual and subject to the 2% floor, such as:

- Ownership costs;
- Tax preparation fees;
- Investment advisory fees; and
- Appraisal fees.

Taxable Income. A trust's taxable income generally includes all gross income received by the trust less the deductions mentioned above; however, a trust may also be entitled to claim a deduction for income and other amounts distributed to its beneficiaries, who then must pay the tax on that income.[98] The deduction depends on the classification of the trust (as either a simple trust or a complex trust) and is subject to a limitation which must be calculated: distributable net income ("DNI") (discussed below).

C. *Simple v. Complex Trusts.*

Simple Trust. A simple trust is defined as any trust that is required to distribute its all of its FAI annually and which does not provide for any amounts to be paid or set aside for charity.[99] A trust may qualify as a simple trust if the trustee is given discretion to "sprinkle" trust income among several beneficiaries, and may even qualify if the trustee fails to actually distribute any trust income.[100] In addition, a trust may qualify as a simple trust for a tax year if the trustee has the *discretion* to distribute trust principal to its beneficiaries or to distribute trust principal pursuant to some standard, such as for a beneficiary's health, education, maintenance or support.[101] However, a trust will not qualify as a simple trust for any tax year in which the trustee *actually* distributes trust principal for any reason, including the termination of the trust.[102]

Complex Trust. A complex trust is, coincidentally, any trust that does not qualify as a simple trust, such as a trust where the trustee has the discretion to pay income and principal as needed for a beneficiary's health, education, maintenance and support.[103] A trust may be classified as a simple trust in some years and a complex trust in others. To illustrate the above concepts, consider the following example: [104]

Example: Assume a trust requires that its trustee, T, distribute the income of the trust annually to its beneficiary, B, and also gives T the sole discretion to distribute some or all of the principal of the trust to B for the health, education, maintenance and support of B. The terms of the trust also provide that the trust terminates once B attains 30 years of age, at which point all remaining trust assets are distributed to B. In Years 1-3, T distributes all of the trust's income to B, but does not distribute any trust principal. In Year 4, T distributes all of the trust's income plus an additional $50,000

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[94] Treas. Reg. § 1.641(b)-1.
[95] Code §§ 642(c) – (f).
[96] Code § 67(e).
[97] *Knight v. Commissioner*, 552 U.S. 181 (2008); Treas. Reg. § 1.67-4.
[98] Code § 651; § 661.
[99] Code § 651(a).
[100] Treas. Reg. §§ 1.651(a)-2(b), 1.651(a)-1.
[101] Treas. Reg. § 1.651(a)-1.
[102] Treas. Reg. § 1.651(a)-3(a).
[103] Treas. Reg. § 1.661(a)-1.
[104] Id.

to B to pay for incurred medical expenses. In Year 5, T distributes all of the trust's income to B, but does not distribute any trust principal. In Year 6, B turns 30 years old, and T distributes all of the trust's assets outright to B.

The trust is a simple trust in Years 1-3 and Year 5. The trust is a complex trust in Year 4 due to the distribution of $50,000 from the principal of the trust. The trust is also a complex trust in Year 6 because the termination of the trust requires the distribution of more than just the income of the trust.

D. *Distributable Net Income.*

As discussed above, a trust may be able to claim a deduction from its adjusted gross income for amounts distributed to its beneficiaries. However, such an amount is capped by the trust's distributable net income ("DNI"). DNI is calculated by making the following adjustments to the trust's adjusted gross income:

Add the Personal Exemption. Any personal exemption claimed by the trust in determining its taxable income must be included in determining DNI.[105]

Subtract Unpaid Capital Gains allocated to principal. As discussed above, capital gains are generally not considered FAI and would not be distributable to a beneficiary who receives mandatory distributions of income. However, the trust instrument and/or state law may provide for (or give the trustee the authority to make) a different allocation of capital gains between income and principal. For example, dividends paid in cash are generally allocated to income under the Texas enactment of the Uniform Principal and Income Act.[106] However, if property other than cash is distributed, or if the distribution is classified as a redemption, capital gain dividend, or a partial liquidation, the assets received may be classified as principal.[107] Also, if the trust agreement requires that capital gains be allocated to income, or are paid, credited, or required to be distributed to a beneficiary, such amounts should not be subtracted. This may provide a planning opportunity as it allows capital gains to be classified as income, which could potentially be distributed to beneficiaries that are not subject to the 3.8% net investment income tax (discussed below).[108]

Add Capital Losses. Capital losses, as with capital gains, are generally excluded from DNI, and so any reductions of taxable income as a result of capital losses should be disregarded. However, to the extent capital losses are used to offset capital gains which are includible in DNI, those capital losses should be included.[109]

Subtract Unpaid Dividends allocated to Simple Trust principal. Similar to the analysis for unpaid capital gains, if amounts received are extraordinary dividends, or if the trustee did not pay or credit taxable dividends to the beneficiaries because, in good faith and in accordance with state law and the trust agreement, the trustee allocated a taxable dividend to trust principal, such dividends should be subtracted from taxable income.[110] However, this adjustment applies only to Simple Trusts.

Add Tax-Exempt Interest. Any interest paid on state and local bonds that are tax-exempt under Code § 103 (less allocated nondeductible expenses) is generally included in calculating DNI unless such interest is paid to a charity for which a charitable deduction is claimed.[111]

Add Any Distribution Deductions. The Code requires that DNI not reflect any deductions for distributions to beneficiaries. This may seem like a strange requirement, seeing as the distribution deduction cannot be calculated until after DNI is known. Nevertheless, if any distribution deductions were reflected in the

[105] Code § 643(a)(2).
[106] Tex. Prop. Code § 116.151.
[107] Id.
[108] Code § 643(a)(3); Treas. Reg. § 1.643(a)-3(b).
[109] Code § 643(a)(3); Treas. Reg. § 1.643(a)-3(b).
[110] Code § 643(a)(4); Treas. Reg. § 1.643(a)-3(b).
[111] Code § 643(a)(5); Treas. Reg. § 1.643(a)-5.

trust's original calculation of taxable income, such deductions must be added back.[112]

To illustrate the above concepts, consider the following example:[113]

Example: Assume XYZ Trust is required to make annual distributions of income to its sole beneficiary, A. The trust agreement governing XYZ Trust provides (and state law allows) for all capital gains and all expenses to be charged against the principal of the trust. During Year 1, the trustee, T, receives on behalf of XYZ Trust $30,000 of corporate dividends, $20,000 of extraordinary dividends (which T allocated to principal), $10,000 of taxable interest from certificates of deposit, $10,000 of tax-exempt interest from municipal bonds, and $10,000 of long-term capital gains from the sale of real estate. XYZ Trust incurred expenses, including T's trustee commission, of $5,000.

XYZ's fiduciary accounting income (FAI) would be $50,000 (consisting of $30,000 of ordinary corporate dividends, $10,000 of taxable CD interest, and $10,000 of tax-exempt muni-bond interest.

XYZ's distributable net income (DNI) would be $45,000 (consisting of $30,000 of ordinary corporate dividends, $10,000 of taxable CD interest, and $10,000 of tax-exempt muni-bond interests, less $5,000 of deductible trust expenses.

E. *Deduction for Distributions to Beneficiaries.*

After DNI has been determined, the amount of the distribution deduction available for a trust can be calculated. This deduction will vary, however, depending on whether the trust is a Simple Trust or a Complex Trust. It is important to remember that any amounts included in distribution deductions from the trust's taxable income must be reflected in the gross income of the recipient beneficiaries. Also, any gross income distributed to a beneficiary from the trust generally has the same character in the hands of the beneficiary as it had in the hands of the trust.[114]

Simple Trust. A Simple Trust is entitled to a deduction for all fiduciary accounting income *required* to be distributed to the beneficiaries, but the deduction cannot exceed DNI.[115] Instead of being taxed at the trust level, that income passes through to the recipient beneficiaries, who must then include the distribution in their gross income.[116] In this sense, Simple Trusts function similar to partnerships. Because tax-exempt income would not be taxable in the hands of either the beneficiaries or the trust, it is not considered for purposes of determining the distribution deduction or the taxable income received by the beneficiary.[117]

Pro Rata Allocations. If DNI exceeds the amount of income the beneficiaries are entitled to receive from a Simple Trust, the beneficiaries include in their gross income the amount of the distributions to which they are entitled. If the amount of income that is required to be distributed from a Simple Trust to its beneficiaries exceeds DNI, the deduction amount (which would be DNI) is allocated pro rata based upon the fraction of FAI each beneficiary is entitled to receive from the trust.[118] To illustrate the above concepts, consider the following example:

Example: Beneficiary A is to receive 2/3 of the income of XYZ Trust, a Simple Trust, while Beneficiary B is to receive 1/3 of XYZ's income. In year 1, XYZ received $150,000 in FAI, so A is entitled to receive $100,000 while B is entitled to receive $50,000.

If XYZ's distributable net income for Year 1 is only $120,000, XYZ will receive a distribution deduction of $120,000 for Year 1. A will include 2/3 of the deduction amount ($120,000 x 2/3 = $80,000) in his gross income, while B will

[112] Code § 643(a)(1).
[113] Treas. Reg. § 1.643(d)-2(a) ex. 1.
[114] Treas. Reg. § 1.652(b)-1; § 1.662(b)-1.
[115] Code § 651; Treas. Reg. § 1.651(b)-1.
[116] Treas. Reg. § 1.652(a)-1.
[117] Treas. Reg. § 1.651(b)-1.
[118] Treas. Reg. § 1.652(a)-2.

include 1/3 of the deduction amount ($120,000 x 1/3 = $40,000) in his gross income.

Complex Trust. A Complex Trust is also entitled to a deduction. The deduction is the sum of the income which is *required* to be distributed to a beneficiary and all amounts (other than income) actually paid, credited, or required to be distributed to a beneficiary. As with Simple Trusts, any tax-exempt income (and expense deductions associated with them) are excluded, and the deduction amount still cannot exceed DNI.[119] However, because distributions of income and principal may be distributed to various classes of beneficiaries, there are rules to determine how much taxable income passes through to each beneficiary.

First Tier Distributions. First Tier Distributions are those distributions which the trustee is required to distribute annually.[120] DNI is first allocated pro rata to each beneficiary's respective share of First Tier Distributions. If the required First Tier Distributions exceed DNI, each First Tier beneficiary includes their pro rata share of DNI in their gross income (based upon their required share of income as a fraction of FAI).

Second Tier Distributions. After all First Tier Distributions have been allocated, any remaining DNI is then allocated pro rata among the recipients of Second Tier Distributions. The following example should explain the First and Second Tier Distribution concepts:

Example: XYZ Trust is required to distribute $50,000 of income annually to Beneficiary A. The trustee of XYZ Trust also has the discretion to distribute additional amounts of income and principal to both A and A's spouse, S. In Year 1, XYZ Trust earns $70,000 of income, and makes total distributions of $60,000 to A and $40,000 to S.

Applying the Tier Distribution rules, $50,000 of DNI is allocated to A as a First Tier Distribution, leaving $20,000 of DNI as Second Tier Distributions. The remaining $20,000 of DNI is allocated among the balance of the Second Tier Distributions in proportion to each beneficiary's respective share of those Second Tier Distributions. Accordingly, A will include an additional $4,000 in his gross income ($20,000 x $10,000 / $50,000), while S will include an additional $16,000 in her gross income ($20,000 x $40,000 / $50,000).

65-day Election. Simple Trusts are generally allowed to deduct income that is required to be distributed, regardless of whether that amount is actually distributed to a beneficiary before the end of the year. For Complex Trusts, required income distributions receive the same treatment, but other distributions of income or principal are only deductible if they are distributed in the current year. To mitigate this, the trustee of a Complex Trust can elect on Form 1041 to treat any amount paid or credited within the first sixty-five days of the next tax year as being distributed on the last day of the preceding tax year.[121]

F. *Trusts and the 3.8% Net Investment Income Tax.*

Chapter 2A of the Code (entitled "Unearned Income Medicare Contribution") was enacted as part of the Health Care and Education Reconciliation Act of 2010. Code § 1411, the only section contained within Chapter 2A, imposes a tax (which, coincidentally, does not benefit the Medicare Trust Fund) on the net investment income of individuals, trusts, and estates whose income is above certain thresholds beginning on January 1, 2013. To avoid confusion with the Medicare self-employment tax of Code § 1401, the tax under Code § 1411 will be referred to as the 3.8% Net Investment Income ("NII") Tax.

A. Net Investment Income.

Net Investment Income, for purposes of the NII Tax, generally includes business income, net gains from the sale of property, and interest, dividend, annuity, royalty, and rental income,

[119] Code § 661(a).
[120] Code § 662(a)(1).
[121] Code § 663(b).

less any allowable deductions that are attributable to such gross income or net gain.[122] However, NII does not include income or gain from certain trade or business activity. Note that this may cause capital gains to be included in Net Investment Income although they are not included in a trust's DNI.

Includable Trade or Business Income. For purposes of determining NII, trade or business income only includes that received from a passive activity (as defined by Code § 469) or from the trading of financial instruments and commodities.[123] As a result, any income received from *per se* passive activities, such as the receipt of oil and gas royalties by a taxpayer that does not hold a working interest, is generally included in NII.[124]

Exclusions from Net Investment Income. NII does not include income subject to self-employment tax, income from qualified retirement plans or IRAs, or income from working capital (as defined in Code § 469(e)(1)(B)). Also, gain from the sale of partnership or S-corporation interests for which the taxpayer is considered an active participant is not included in NII to the extent the sale of the underlying assets of the partnership or S-corporation would not also be considered investment income.[125]

In addition, NII does not include items that are not otherwise included in taxable income, such as:

- Tax-Exempt Interest (Code § 103);
- Gain from the sale of a Principal Residence (up to the limits of Code § 121);
- Gain from the sale of Qualified Small Business Stock (Code § 1202); and
- Excluded gain from like-kind exchanges or involuntary conversions (Sections 1031, 1033).

Application to Trusts. For non-grantor trusts, the amount subject to the 3.8% NII Tax is the lesser of undistributed net investment income and the trust's adjusted gross income subject to the highest trust income tax bracket.[126] The Code does not define undistributed net investment income, so tax practitioners must look to the regulations for guidance.[127]

Undistributed Net Investment Income. If a trust does not receive any business income or proceeds from a qualified plan or IRA, determining undistributed net investment income seems to be straight-forward: it is the trust's taxable income. However, if the trust receives income from items not subject to the NII Tax (referred to in the regulations as "excluded income"), distributions from the trust must be apportioned to determine what fraction of NII is carried out to the beneficiaries, taking into account deductions for charitable distributions and set-asides.[128] To illustrate:

Example 1: Assume XYZ Trust has $15,000 of dividend income, $10,000 of interest income, $25,000 of capital gain, and $50,000 of taxable income as a result of a distribution from a traditional IRA. XYZ distributes $50,000 of its income to its beneficiary, A, and has no deductible expenses. The trustee of XYZ Trust allocates all of the trust's capital gain to principal, in accordance with local law and the trust agreement.

XYZ Trust has DNI of $75,000, comprised of all of the dividends, all of the interest, and all of the income from the IRA. XYZ Trust will claim a $50,000 deduction for the distribution to A. This deduction constitutes 2/3 (66.67%) of the trust's total DNI and will be applied proportionally to all of XYZ Trust's DNI items. As a result, the distribution consists of $10,000 of dividend income, $6,667 of interest income,

[122] Code § 1411(c)(1).
[123] Code § 1411(c)(2).
[124] Code § 469(c)(3)(A).
[125] Code § 1411(c)(1)(A)(iii).
[126] Code § 1411(a)(2).
[127] Treas. Reg. § 1.1411-3(e).
[128] Treas. Reg. §§ 1.1411-3(e)(3), (4).

and $33,333 of taxable IRA income. Note that none of the capital gains are attributed to the distribution for purposes of calculating the distribution deduction.

On the other hand, XYZ Trust has $50,000 of net investment income, consisting of $15,000 of dividend income, $10,000 of interest income, and $25,000 of capital gain. Note that the taxable IRA income is not included in calculating NII. From this $50,000, we deduct the amount of net investment income that was deemed distributed, which includes $10,000 of dividend income, and $6,667 of interest income. As a result, XYZ Trust has $33,333 of undistributed net investment income, comprised of $25,000 of capital gain, $5,000 of undistributed dividend income, and $3,333 of undistributed interest income. Remember, the Traditional IRA distribution is not included in the calculation of Net Investment Income.

Example 2: How would *Example 1* change if the XYZ Trust agreement instead provided that capital gains were all allocated to principal? In that scenario, XYZ Trust would have $100,000 of DNI, comprised of all of the dividend income, all of the interest, all of the IRA income, and all of the capital gain income. Assuming again that the trust will distribute $50,000 to A, XYZ Trust will still claim a $50,000 deduction for the distribution to A. However, the deduction will be apportioned ½ (50%) to each item of DNI. As a result, the distribution would consist of $7,500 of dividend income, $5,000 of interest income, $25,000 of IRA income, and $12,500 of capital gain.

XYZ Trust still has $50,000 of net investment income because capital gains are included in NII regardless of whether or not they are included in DNI. However, because a portion of capital gain is treated as DNI, the trust can now claim a deduction of a portion of the capital gains for purposes of the net investment income tax. Now, from the $50,000 of NII, we deduct $7,500 of dividend income, $5,000 of interest, and $12,500 of capital gains, leaving only $25,000 of undistributed net investment income. The ability to classify capital gains as income has led to $8,333 in undistributed net investment income.

G. *Trusts and Material Participation.*

Generally, a taxpayer's income is exempt from passive activity treatment if the taxpayer materially participated in the activity giving rise to that income.[129] For rental activity, special material participation rules apply.[130] While the Code does give guidance on application of the material participation rules in the context of C corporations and limited partnerships, no such guidance is available for trusts. In addition, the Treasury Department has (so far) failed to promulgate regulations giving any guidance on the subject. The Senate Report accompanying the Tax Reform Act of 1986 suggests that a trust can materially participate so long as "an executor or fiduciary, in his capacity as such, is so participating."[131] With virtually no clues from either the Congress or the Treasury Department, guidance would have to come from the judiciary.

Mattie K. Carter Trust v. U.S. Before 2014, only one case has considered whether or not a trust could materially participate.[132] In *Carter Trust*, a 15,000 acre cattle ranch was owned by a trust, whose trustee reviewed the financial affairs of the ranch, but was not in any meaningful sense materially participating in the day-to-day operations of the ranch. However, the ranch did have several employees and a manager who were hired by the trustee. The IRS argued that the trust did not materially participate because the trustee was not regularly, continuously and substantially involved in the operations of the ranch. The IRS rejected the trustee's attempt to report the income from the ranch as an active trade or business, causing the trust to have passive activity losses, and argued before the federal district court that the Senate Report supported their interpretation.

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[129] Code § 469(c)(1).
[130] Code § 469(c)(7)(B).
[131] Sen. Rep. No. 99-313, at 735 (1986).
[132] *Mattie K. Carter Trust v. U.S.*, 256 F. Supp. 2d 536 (N.D. Tex. 2003) (mem. op.).

In granting the trust's motion for summary judgment, the court agreed with the trust's argument that a trust, like a corporation, can only act through its agents, employees, and fiduciaries, and that the activities of *all* those persons should be considered for the purposes of determining material participation, not just the trustee.

TAM 200733023. Unwilling to let a memorandum opinion from a federal district court spoil its fun, the IRS stood by its belief that material participation could only be satisfied by a trustee. In a subsequently published advice memorandum, the IRS considered whether the activities of "special trustees" who were contracted by the "real" trustees to perform business service activities that ordinarily would rise to the level of material participation.[133] However, the special trustees lacked the power to bind or commit the trust in any transaction or activity. Deciding that the interpretation of the federal district court in *Carter Trust* was wrong, the IRS determined that the special trustees were not fiduciaries in any real sense, and that the "real" trustees did not materially participate in the trust's activities. As a result, the trust had to cope with the passive activity loss rules.

TAM 201317010. In a more recent advice memorandum, the IRS also ruled that the activities of another special trustee could not be counted towards the trust's material participation.[134] Even though the special trustee also served as the president of the company, he lacked any real fiduciary power or responsibility over the trust. The IRS again determined that only the activities of "real" trustees, acting in their capacities as fiduciaries, could count towards the trust's material participation.

Frank Aragona Trust v. Commissioner. In *Aragona Trust*, the grantor, Frank Aragona, created a trust in 1979 to hold his real estate business activities for the benefit of his five children.[135] The trust's assets included a wholly-owned LLC which held all of its rental real estate business, and for which three of the children were employed full-time. After the grantor's death in 1981, his five children served as co-trustees, together with an independent co-trustee. Two of the children who were employed by the LLC also owned minority interests in other real estate entities of which the trust was the majority owner. The trust, believing that it materially participated in real estate activities as a real estate professional, claimed losses against other non-passive income. Disagreeing with the trust, the IRS determined that the trust did not materially participate in real estate activities, re-classified the claimed losses as passive activity losses, and issued a notice of deficiency due to the disallowed losses.

At trial, the IRS argued that a trust could never qualify as a real estate professional because a trust, as an entity, cannot perform personal services.[136] The IRS also argued in the alternative that the trust did not materially participate in real estate activity because the employee-trustees were not participating in their capacities as trustee, but were acting in their roles as either employees and/or investors; as such, the activities of those trustees outside their roles as a fiduciary one could not consider.

The Tax Court first ruled that trust could, in fact, perform personal services to qualify as a real estate professional because trusts are generally considered "taxpayers" for purposes of Code § 469.[137] Also, the Tax Court noted that a closely-held C-corporation, itself an entity, could perform personal services through the actions of its agents. Therefore, the trust could perform personal services through the actions of its trustees, who manage the trust's assets in the interest of its beneficiaries.

Next, the Tax Court looked to whether the trust qualified under the real estate professional exception of Code § 469(c)(7). The Tax Court rejected the argument of the IRS that the employee-trustees were acting outside of their

[133] TAM 200733023.
[134] TAM 201317010.
[135] *Frank Aragona Trust v. Comm'r.,* 142 T.C. 9 (2014).
[136] See Code § 469(c)(7)(B)(i).
[137] Code § 469(a)(2)(A).

fiduciary capacities so their activities should be disregarded. It found that Michigan law imposed a fiduciary duty upon the employee-trustees to act solely in the best interests of the trust's beneficiaries at all times; as a result, even when acting as an employee of the trust's wholly-owned LLC, the employee-trustees were acting in a fiduciary capacity. Looking to the activities of the trustees in relation to the wholly-owned LLC, the Court made the following findings:

- The three employee-trustees participated in the trust's real estate operations full-time;

- The trust's real-estate operations were substantial;

- The trust has no other types of operations other than real estate; and

- The employee-trustees handled almost no other businesses on behalf of the trust.

The Tax Court accordingly found that the trust materially participated in real-estate activities, despite the fact that two employee-trustees also owned a minority interest in the trust's other real estate holdings. It noted that the interests owned by the trustees were minority interests and that their combined interest did not exceed the interest of the trust in those in related real estate businesses. Because the IRS did not raise any arguments regarding the trust's failure to satisfy either the "750 hour" test or the "one-half of personal services" test under Code § 469(c)(7), the Tax Court ultimately ruled in favor of the trust.

Current Relevance with the 3.8% NII Tax and Additional Questions. With the application of the 3.8% net investment income tax, the material participation of a trust has taken on increased significance. As a result, a consideration of the factors identified by the Tax Court in *Aragona Trust* could potentially provide some tax planning opportunities.

For instance, the founder of a business, with an eye towards transitioning ownership of the business to his children through a trust, may wish to consider appointing his children who have an active role in the operations of the business as trustees. However, with only a pair of cases and no regulatory guidance, there are still some questions that remain.

Shared Ownership. In Aragona Trust, because the LLC was a disregarded entity, all of the real estate activities of the employee-trustees were ultimately attributable to the trust. Whether this would change if the trust owned less than all of the interests in the LLC is unknown.

Limited Fiduciary Responsibility. In Aragona Trust, the Tax Court put emphasis on the fact that local law required the trustee to maintain his fiduciary duty to the trust at all times and in all of the trustee's dealings. As a result, the trustee could never cease to act as a fiduciary, even when serving as an employee of the trust (or an LLC wholly-owned by the trust). Also, the IRS has made clear in previous advice memoranda that limitations of a trustee's fiduciary responsibilities to the trust raise questions. It is possible that the trust law of other States, or the provisions of a trust agreement, could allow the trustee to shed their fiduciary duties when not strictly acting as the trustee of the trust. For example, the terms of a trust agreement could allow the trustee to engage in activities where there is a conflict of interest, or in transactions that constitute self-dealing on the part of the trustee. If so, then perhaps not all the activities of a trustee also serving as a trust employee are properly attributable to the trust. And while the federal district court in Carter Trust was willing to look to the activities of a trust's employees, the Tax Court in Aragona Trust rendered its verdict without reaching the issue. As a result, any tax planner should carefully consider whether a trust agreement should specifically require that trustees act in a fiduciary capacity when employed by a trust-owned entity. However, the materially-participating trustee should also be made aware of the potential liability associated with such a broad duty to the trust and its beneficiaries.

Possible Business Trust Issues. Although unlikely in the context of rental real estate, the IRS could argue that a trustee's activites were devoted so heavily to trade or business activity, in contrast with his fiduciary duties, that the purpose of the trust itself was not the mere management of trust assets. Instead, the IRS could argue that the trust was merely "a device to carry on a profit-making business[.]"[138] As the Tax Court mentioned in a footnote of Aragona Trust, the IRS did not raise the argument that the trust, as a business trust, should be considered an association, subject to taxation as a corporation.[139] Although likely a specious argument in most cases, the detriment of a trust being subject to double taxation as a corporation is nothing to ignore.

Trust Guidance on § 469 now a "Priority". The Tax Court in *Aragona Trust* noted that the Treasury Department has never issued guidance regarding the material participation of trusts and estates.[140] After suffering defeat twice in the courts, the Treasury Department has decided that, perhaps, some regulatory pronouncements might be in order. As a result, "[g]uidance regarding material participation by trusts" is now listed along with 317 other "priority" projects noted by the Treasury Department. If and until any regulations are released, tax practitioners will have to rely upon *Carter Trust*, *Aragona Trust* and non-precedential IRS rulings for guidance in seeking to finesse the passive activity loss rules and the net investment income tax.

[138] Treas. Reg. § 301.7701-4(b).
[139] *Frank Aragona Trust v. Commissioner*, 142 T.C. 9 (2014) at n.11.
[140] Treas. Reg. § 1.469-5T(g).

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2017 Advanced Tax Law Course

Trust Distributions to Foreign Beneficiaries

JOHN R. STROHMEYER

INCOME TAX RESIDENTS

- U.S. Citizens
- Legal Permanent Resident (a.k.a. the “Green Card” Test)
- Substantial Presence Test
  - 31 days in the tax year in question
  - 183 days over the tax year in question and the previous two tax years
    - Days during the tax year in question fully counted
    - Days during immediately preceding tax year counted 1/3
    - Days during tax year two years before counted 1/6
- First-year election
  - Must be substantially present in the subsequent tax year

INCOME TAXATION OF TRUSTS & ESTATES

Trusts and estates are taxable entities that are subject to tax on worldwide income.

- Trusts and Estates annually file IRS Form 1041
- Estates may elect a fiscal year.
- Trusts and estates pass items of income and deductions to beneficiaries
- Generally may take deductions and credits available to a individual.
- Charitable deduction linked to income distributed, not fair market value.
- Distribution deduction for DNI carried out to beneficiaries.

INCOME TAXATION OF TRUSTS & ESTATES

"Income" for a trust can mean:

- Fiduciary Accounting Income
  - The amount of income of the trust under the governing instrument and state law. Code § 643(b).
  - Items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing income and applicable local law shall not be considered income.
- Taxable Net Income
- Distributable Net Income
- (Undistributed) Net Investment Income

INCOME TAXATION OF TRUSTS & ESTATES

Distributable Net Income – Start with Adjusted Gross Income

- Add:
  - Personal Exemption
  - Capital Losses
  - Tax-Exempt Interest unless allocated to charities
  - Distribution Deductions
- Subtract:
  - Unpaid Dividends allocated to Simple Trust Principal
  - Unpaid Capital Gains allocated to Principal

DISTRIBUTIONS FROM ESTATES

- Specific bequest exception
- Separate share rule
- Interest on funding pecuniary bequests
- Distribution of property in satisfaction of pecuniary bequest
- Distribution of IRD to satisfy pecuniary bequest
- In-kind distributions are typically not taxable under Rev. Rule 69-486

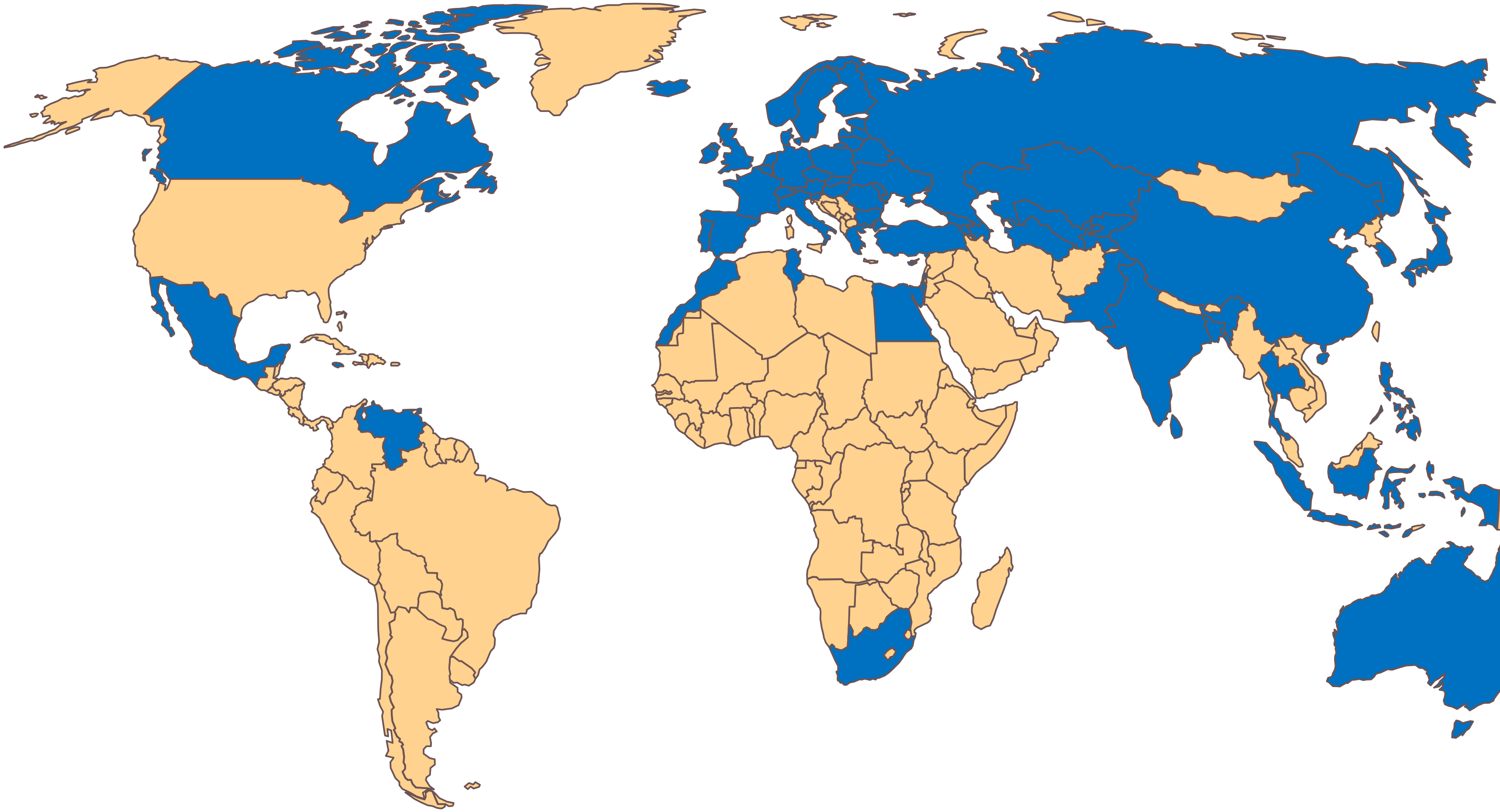
DISTRIBUTIONS TO FOREIGN BENEFICIARIES

- Generally, payments to nonresidents are subject to mandatory withholding, regardless of character.
  - Nonresidents will not file a Form 1040NR to report distributions and remit tax if withholding is sufficient.
  - Character of receipts in the hands of a trustee will determine the character in the hands of the beneficiary.
- To ensure that the US income tax is paid, trustees must report distributions on Form 1042-S and withhold tax at a rate of 30% on the gross amount of distributions to foreign beneficiaries.
  - Additional Forms 1042-S must be completed for each type of income that is not withheld at the statutory withholding rate.
  - Income exempt from withholding must be reported on Form 1042-S.
- Trustees must also file Forms 1042 and 1042-T.

U.S. INCOME TAX TREATY SYSTEM

- The U.S.A. is a party to 59 bilateral income tax treaties with 66 countries.
  - The U.S.-U.S.S.R income tax treaty applies to Armenia, Azerbaijan, Belarus, Georgia, Krgyzstan, Tajikistan, Turkmenistan, and Uzbekistan.
  - The U.S.-China income tax treaty does not apply to Hong Kong.
- Four protocols amending existing treaties have been signed but not approved by the Senate.
  - Japan signed in 2013 amending the 2003 treaty
  - Luxembourg signed in 2009 amending the 1996 treaty
  - Spain signed in 2013 amending the 1990 treaty
  - Switzerland signed in 2012 amending the 1996 treaty
- Four treaties have been signed but not approved by the Senate.
  - Chile signed in 2010 (first treaty)
  - Hungary signed in 2010 replacing 1979 treaty
  - Poland signed in 2013 replacing the 1974 treaty
  - Vietnam signed in 2015 (first treaty)

U.S. INCOME TAX TREATY PARTNERS



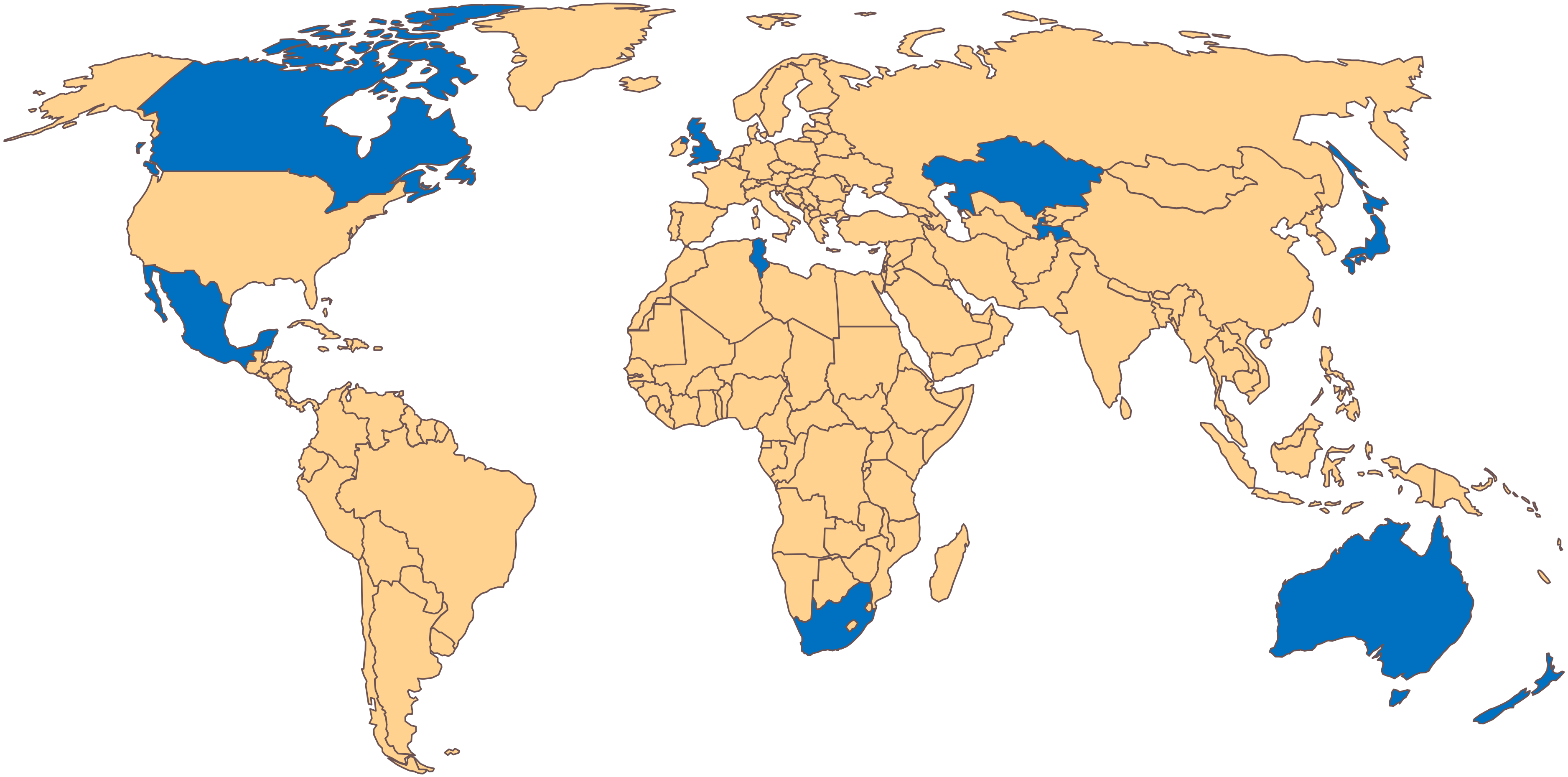
RELEVANT TREATY ARTICLES

- Article 2—Taxes Covered
- Article 3—General Definitions
- Article 4—Resident
- Article 5—Permanent Establishment
- Article 6—Income From Real Property
- Article 7—Business Profits
- Article 10—Dividends
- Article 11—Interest
- Article 12—Royalties
- Article 13—Gains

TREATY COMPARISONS

- Australia (effective Dec. 1, 1983, Protocol Jan. 1, 2004)
- Canada (effective Jan. 1, 1985, Protocols Jan. 1, 1996, Dec. 16, 1997, and Jan. 1, 2009)
- Japan (effective Jan. 1, 2005)
- Kazakhstan (effective Jan. 1, 1996)
- Mexico (effective Jan. 1, 1994, Protocols Oct. 26, 1995 and Jan. 1, 2004)
- New Zealand (effective Nov. 2, 1983, Protocol Jan. 1, 2011)
- South Africa (effective Jan. 1, 1998)
- Tajikistan (U.S.-U.S.S.R. Income Tax Treaty) (effective Jan. 1, 1976)
- Tunisia (effective Jan. 1, 1990)
- United Kingdom (effective Jan. 1, 2004)

U.S. INCOME TAX TREATY COMPARISON



DIVIDENDS (ARTICLE 10)

Tax Rate on Dividends Paid by U.S. Corporations

- No Treaty – 30%
- Model Treaty – 5% if owner has 10% ownership, 15% otherwise
- Australia – 15%
- Canada – 15%
- Japan – 10%
- Kazakhstan – 10%
- Mexico – 10%
- New Zealand – 15%
- South Africa – 15%
- Tajikistan – 30%
- Tunisia – 15%
- United Kingdom – 15%

INTEREST (ARTICLE 11)

Tax Rate on Interest Income Paid by U.S. Obligors

- No Treaty – 30%
- Model Treaty – 15%
- Australia – 10%
- Canada – 0%
- Japan – 10%
- Kazakhstan – 10%
- Mexico – 15%
- New Zealand – 10%
- South Africa – 0%
- Tajikistan – 0%
- Tunisia – 15%
- United Kingdom – 0%

BASIS REPORTING FOR ESTATE TAX
IRS FORM 8971

- Property Subject to Basis Consistency Requirement
- Property Exempt from Reporting
- Penalties for Failure to File Information Return
- Certain foreign beneficiaries don't need to obtain a TIN for Form 8971 reporting

PUTTING IT TOGETHER

- Harold, a U.S. citizen, dies leaving his estate to his wife, Wendy, also a U.S. citizen, and their three children:
  - Michael, a U.S. citizen living in Australia
  - Tony, a nonresident alien living in Brazil
  - David, a nonresident alien living in the U.K.
- Wendy, as Harold's executor, is taking her time distributing assets from the estate, so Michael, Tony, and David are each entitled to $10,000 in interest payments on their pecuniary bequests.

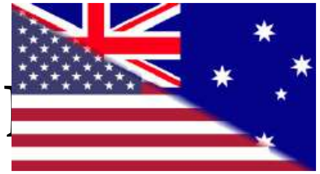
PUTTING IT TOGETHER

- Harold's will contains a specific bequest of $100,000 to each of Michael, Tony, and David.
- It also specifically leaves Harold's Mexico vacation property held in a Fideicomiso to Michael.
- The following assets may pass to Michael, Tony, and David as residuary bequests:
- Harold's community property interest in a brokerage account
- U.S. commercial real property owned as Harold's separate property
- 35% interest in Harold's Holistic Health Foods LLC, an S corporation
- 300 shares of Harold's Haberdashery Inc., a C corporation
- 100% interest in Harold's Hangers LLC, a tax partnership

PUTTING IT TOGETHER – MICHAE

- Distributions to Michael are not subject to special withholding because he is a U.S. citizen.
- The U.S. – Australia income tax treaty applies, but Michael does not benefit from it per Article 1.
  - 35% interest in Harold's Holistic Health Foods LLC, an S corporation
    - Michael is an eligible shareholder
  - Specific bequest of $100,000 and Mexican vacation home
    - Not includable in Michael's gross income
    - Not deductible by the estate, and do not carry out DNI
  - $10,000 Interest on Pecuniary Bequests
    - Includable in Michael's gross income
    - Not deductible by the estate, and does not carry out DNI

PUTTING IT TOGETHER – MICHAEL



- Harold’s community property interest in a brokerage account
  - Dividends and Interest paid to the estate and distributed to Michael will be included in Michael’s gross income.
- U.S. commercial real property owned as Harold’s separate property
  - Gain on Sale by the estate and distributed to Michael will be included in Michael’s gross income, and taxed at capital gains rates
- 300 shares of Harold’s Haberdashery Inc., a C corporation
  - Dividends paid to the estate and distributed to Michael will be included in Michael’s gross income
- 100% interest in Harold’s Hangers LLC
  - Distributions paid to the estate and distributed to Michael will be included in Michael’s gross income

PUTTING IT TOGETHER – TONY

- Distributions to Tony are subject to special withholding because he is a nonresident alien.
- No income tax treaty applies.
  - 35% interest in Harold's Holistic Health Foods LLC, an S corporation
    - Tony is not an eligible shareholder
  - Specific bequest of $100,000
    - Not includable in Tony's gross income
    - Not deductible by the estate
    - Not subject to withholding, and not reported on Form 1042-S
  - $10,000 interest on pecuniary bequests
    - Includable in Tony's gross income, not deductible by the estate
    - Subject to 30% FDAP withholding

PUTTING IT TOGETHER – TONY

- Harold's community property interest in a brokerage account
  - Dividends paid to the estate and distributed to Tony will be included in Tony's gross income, subject to 30% FDAP withholding.
  - Interest paid to the estate and distributed to Tony will likely qualify for the portfolio interest exception, so not subject to 30% FDAP withholding, but reported on Form 1042-S
- 100% interest in Harold's Hangers LLC
  - Effectively Connected Income paid to the estate and distributed to Tony will be included in Tony's gross income.
  - ECI subject to 39.6% withholding, and Tony will need to file a return to report applicable deductions and pay tax at graduated rates.

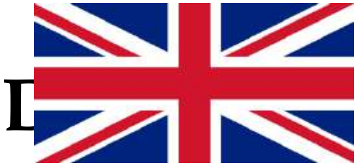
PUTTING IT TOGETHER – TONY

- U.S. commercial real property owned as Harold's separate property
  - Rent received by the estate and distributed to Tony will be subject to 30% FDAP withholding, unless he elects to treat as ECI
  - Gain on sale will be included in Tony's gross income, and taxed at capital gains rates, subject to 15% FIRPTA withholding
- 300 shares of Harold's Haberdashery Inc., a C corporation
  - Dividends paid to the estate and distributed to Tony will be included in Tony's gross income, subject to 30% FDAP withholding
  - Distributions of shares to Tony are corpus distributions, and not subject to withholding
  - Tony's later sales of the shares are not subject to withholding, and not subject to capital gains tax

PUTTING IT TOGETHER – DAVID

- Distributions to David are subject to special withholding because he is a nonresident alien.
- The U.S. – U.K. income tax treaty applies.
  - 35% interest in Harold's Holistic Health Foods LLC, an S corporation
    - David is not an eligible shareholder
  - Specific bequest of $100,000
    - Not includable in David's gross income
    - Not deductible by the estate
    - Not subject to withholding, and not reported on Form 1042-S
  - $10,000 interest on pecuniary bequests
    - Not includable in David's gross income, not deductible by the estate
    - Not subject to withholding , but reported on Form 1042-S

PUTTING IT TOGETHER – DAVID



- Harold's community property interest in a brokerage account
  - Dividends paid to the estate and distributed to David will be included in David's gross income, subject to 15% FDAP withholding
  - Interest paid to the estate and distributed to Tony is exempt from tax under the Treaty and likely qualifies for the portfolio interest exception, so not subject to 30% FDAP withholding, but reported on Form 1042-S
- 100% interest in Harold's Hangers LLC
  - Effectively Connected Income paid to the estate and distributed to David will be included in David's gross income.
  - ECI subject to 39.6% withholding, and David will need to file a return to report applicable deductions and pay tax at graduated rates.

PUTTING IT TOGETHER – DAVID

- U.S. commercial real property owned as Harold's separate property
  - Rent received by the estate and distributed to David will be subject to 30% FDAP withholding, unless he elects to treat as ECI.
  - Gain on sale will be included in David's gross income, and taxed at capital gains rates, subject to 15% FIRPTA withholding.
- 300 shares of Harold's Haberdashery Inc., a C corporation
  - Dividends paid to the estate and distributed to David will be included in David's gross income, subject to 15% FDAP withholding
  - Distributions of shares to David are corpus distributions, and not subject to withholding.
  - David's later sales of the shares are not subject to withholding, and not subject to capital gains tax

PUTTING IT TOGETHER—REPORTING

- Form W-9 for Wendy and Michael
- Form W-8BEN for Tony and David
- Form 8833 for David when filing Form 1040NR
- Form 1042-S—Foreign Person's U.S. Source Income Subject to Withholding
  - Five for Tony—39.6% ECI, 15% FIRPTA, 0% FDAP, and 30% FDAP (2)
  - Six for David—39.6% ECI, 15% FIRPTA, 0% FDAP (2), 15% FDAP, and 30% FDAP
- Form 1042—Annual Withholding Tax Return for U.S. Source Income of Foreign Persons
  - Filed by Wendy as executor
- Form 1042-T—Annual Summary and Transmittal of Forms 1042-S
  - Filed by Wendy as executor
- Form 8971
  - Will list Wendy, Michael, Tony, and David (Tony and David will need a TIN.)

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This outline was written for the TexasBarCLE Advanced Tax Law Course presented on August 17, 2017. Any statement in this presentation is not written or intended to be used, and cannot be used, for the purpose of (i) avoiding tax penalties, or (ii) promoting, marketing, or recommending to another person the tax treatment of any transaction or matter. Any recipient should seek advice based on the recipient's particular circumstances from an independent tax advisor.

TAX SECTION
State Bar of Texas

June 23, 2017

Via Certified Mail Return Receipt Requested & Via Email

Laurie E. Brimmer@irs.gov
FR Document: 2017-08155
Laurie E. Brimmer
Internal Revenue Service
Room 6526
1111 Constitution Ave. NW
Washington, DC 20224

RE: Comments on Notice Issued April 24, 2017, Document Number 2017-08155, 82 FR 18969

Dear Ms. Brimmer:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Department of Treasury ("Treasury") and Internal Revenue Service ("IRS") in the Notice issued on April 24, 2017, Document Number 2017-08155, 82 FR 18969 (the "Notice").

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend Treasury and the IRS for inviting comments on the process of collecting information via the filing of a United States Gift (and Generation-Skipping Transfer) Tax Return, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Stephanie Schroepfer

Stephanie Schroepfer, Chair
State Bar of Texas, Tax Section

COMMENTS ON NOTICE ISSUED ON APRIL 24, 2017, DOCUMENT NUMBER 2017-08155, 82 FR 18969

These comments on the above-referenced Notice ("Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafters of these Comments were Laurel Stephenson, Co-Chair of the Estate and Gift Tax Committee, Celeste C. Lawton, Co-Chair of the Estate and Gift Tax Committee, and Carol Warley, Vice-Chair of the Estate and Gift Tax Committee. The Committee on Government Submissions (COGS) of the Tax Section of the State Bar of Texas has approved these Comments. Henry Talavera, Co-Chair of COGS, reviewed these Comments. Lora G. Davis, a current member of the Tax Section Council, and Melissa Willms, a former member of the Tax Section Council, also reviewed the Comments and made substantive suggestions on behalf of COGS.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: June 23, 2017

I. INTRODUCTION

These Comments are in response to the Notice issued on April 24, 2017, Document Number 2017-08155, 82 Federal Register 18969 (the "Notice"), by the IRS and Treasury, inviting comments on the process of collecting information in conjunction with the filing of an IRS Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return (a "Form 709").

As outlined in more detail below, we would appreciate being granted the ability to e-file Form 709. We would also appreciate the IRS' clarifying in the Form 709 instructions (the "Instructions") that if the election pursuant to Code § 2513 is made, then (i) gifts of community property do not need to be split and (ii) certain gifts are not eligible for gift-splitting.[1]

We recognize and appreciate the time and thoughtful work invested by the Treasury and the IRS in preparing and continually updating Form 709 and the Instructions to take into account statutory and regulatory changes. These efforts are extremely helpful to taxpayers and practitioners. It is our intent to present items for consideration that may help and support Treasury and the IRS in this endeavor. We greatly appreciate the opportunity to work with the Service on these significant tax issues and hope these Comments provide relevant analysis for your review. Thank you for your consideration.

II. COMMENTS REGARDING THE EXTENSION OF PERMITTED ELECTRONIC FILING TO FORM 709

We respectfully request that taxpayers be allowed to file Form 709 electronically ("e-filing" or "e-file"), as is already permitted with regard to (for example) both (i) a Form 1040, U.S. Individual Income Tax Return and (ii) a Form 1041, U.S. Income Tax Return for Estates and Trusts. Many of the same procedures adopted in conjunction with the e-filing of those and other returns may be similarly applied with the e-filing of a Form 709 (e.g., the scope of Form 8879, IRS *e-file* Signature Authorization could be appropriately extended for this purpose with only minor modifications).

On occasion, there are additional documents to file with Form 709, such as a trust instrument or qualified appraisal. Those documents could be easily filed as a PDF attachment to the e-filed Form 709. Notably, a "qualified appraisal" may already be e-filed as a PDF attachment in conjunction with a Form 8283, Noncash Charitable Contributions.

If the length of a trust instrument is a concern, the Form 709 reporting the initial gift to the subject trust could be e-filed and the trust instrument subsequently forwarded to the IRS by

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[1] All references herein to the "Code §" or "Section" are to the Internal Revenue Code of 1986, as amended, and all references to "Treas. Reg. §" and "Prop. Reg. §" are to the current and the proposed regulations promulgated thereunder, respectively.

mail as an enclosure with an appropriately modified Form 8453, U.S. Individual Income Tax Transmittal for an IRS *e-file* Return. Subsequent gifts to the trust could then be reported on e-filed Forms 709 providing a brief description of the trust's terms (as permitted by the Instructions).

The election by spouses to "gift-split" pursuant to Code § 2513 could also be easily accommodated by requiring spouses to e-file their Forms 709 together as a single submission, much like the current requirement that spouses making the election file their Forms 709 in the same envelope.

As noted in the IRS Oversight Board's *"Electronic Filing 2013 Annual Report to Congress,"* e-filing benefits both taxpayers and the IRS. Taxpayers are given the ability to provide highly personal information in a secure, confidential, and convenient manner and confirm instantaneously the successful submission of the return. In turn, the IRS has experienced significant reductions in its processing costs, which translates into additional funding for customer service and enforcement initiatives.

The *2013 Annual Report* goes on to provide that "e-file lays the groundwork for further improvements in tax administration because it accurately captures the information on returns in a digital fashion." We would suggest that the ability to capture information digitally, such as income tax basis information relating to noncash gifts, would seem particularly useful to the IRS. For example, if a donee in receipt of a noncash gift were to later sell that asset, verifying the gain or loss reported on the donee's Form 1040 for the year of sale requires a comparison of the associated basis information reflected on the Form 1040 to that disclosed on the donor's Form 709 (plus interim adjustments to basis, if applicable). If the donor's Form 709 were e-filed, the examiner would appear to have an easily accessible and accurate means of instantly verifying the basis information reported on the Form 1040.

III. COMMENTS REGARDING INSTRUCTIONS ON GIFT-SPLITTING REPORTING

We respectfully request that the Instructions to Form 709 be revised to clarify that (1) gifts of community property do not need to be split and (2) certain gifts are not eligible for gift-splitting for the reasons that follow.

A. No Need to Split Gifts of Community Property

The section of the Instructions entitled "Who Must File" makes it clear that a gift of community property is considered made one-half by each spouse. Thus, if all the gifts that an individual and the individual's spouse make are gifts of community property, each of them would report one-half of the gifts on their respective gift tax return, and there would be no need for the spouses to split the community property gifts if they want the gifts to be considered as having been made one-half by each of them. In other words, the characterization of the gifted property as community property means that a gift of the property does not need to be split. However, many tax professionals believe that gift-splitting is necessary in order to ensure that spouses' gifts will be considered made one-half by each of them, regardless of the characterization of the property. Accordingly, we respectfully request that the Instructions be modified to include additional clarification in this regard. Following is an example of a proposed paragraph that could be added in the section entitled "Split Gifts" (with a recommended placement before the text beginning with "Line 15"):

> "If you and your spouse make a timely and appropriate gift-splitting election for the calendar year and each of you also make a gift of community property, you should report one-half of any community property gifts on your gift tax return in the top half of Part 1, 2, or 3 (as applicable) of Schedule A, and your spouse should correspondingly report the other half of any community property gifts on his or her gift tax return in the top half of the same Part of Schedule A. For example, if you and your spouse made a gift of $100,000 of community property to a child, you would report a $50,000 gift of community property on Part 1, Schedule A of your gift tax return, and your spouse would report a $50,000 gift of community property on Part 1, Schedule A of his or her gift tax return. Your gift tax return would not report any portion of your spouse's $50,000 gift of community property, and your spouse's gift tax return would not report any portion of your $50,000 gift of community property."

B. Certain Gifts Not Eligible for Gift Splitting

Under the heading "Split Gifts," the Instructions provide that "all gifts made by both you and your spouse to third parties during the calendar year…must be split" (referred to below as the "Gift Split Mandate"). However, some gifts are not eligible for gift-splitting. For example, gifts that are not eligible for gift-splitting include a gift of property by a donor spouse to a third party if the non-donor spouse has a general power of appointment over such property. In addition, if a donor spouse makes a gift of property to a trust for which the non-donor spouse is a beneficiary, a portion of the gift may not be eligible for gift-splitting (as outlined in Treas. Reg. § 25.2513-1(b)). Nevertheless, some tax practitioners will report gifts that are not eligible for gift-splitting as if they were eligible because the Instructions expressly state that "all gifts" must be split. Accordingly, we suggest that the instructions be modified to add a clarification similar in nature to the following underlined clause at the end of the Gift Split Mandate:

> "The consent is effective for the entire calendar year; therefore, all gifts made by both you and your spouse to third parties during the calendar year (while you were married) must be split, <u>except with respect to any portion of the gift that is not eligible for gift-splitting due to that portion failing to have been considered "ascertainable" at the time of the gift and severable from the interest transferred to your spouse (as described in Treas. Reg. § 25.2513-1(b).</u>"

TAX SECTION
State Bar of Texas

August 1, 2017

Via Federal eRulemaking Portal
At www.regulations.gov

Internal Revenue Service
CC:PA:LPD:PR (REG-136118-15)

Courier's Desk
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

RE: Comments on Proposed Regulations Regarding Implementing Centralized Partnership Audit Regime

Dear Ladies and Gentlemen:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Department of the Treasury ("Treasury") and Internal Revenue Service (the "IRS" or "Service") in the Notice of Proposed Rulemaking (REG-136118-15) issued on June 13, 2017 (the "Proposed Regulations"). The Proposed Regulations provide rules concerning the implementation of the new centralized partnership audit regime (the "Centralized Audit Regime") enacted by section 1101 of the Bipartisan Budget Act of 2015, as corrected and clarified by the Protecting Americans from Tax Hikes Act of 2015.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW. THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL

OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend Treasury and the Service for the time and thought that has been put into preparing the Proposed Regulations, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted

Stephanie Schroepfer

Stephanie S. Schroepfer, Chair
State Bar of Texas, Tax Section

SS/lab
Enclosures

COMMENTS ON PROPOSED REGULATIONS IMPLEMENTING CENTRALIZED PARTNERSHIP AUDIT REGIME

These comments on the Proposed Regulations (the "Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafters of these Comments were Richard L. Hunn, Co-Chair of the Tax Controversy Committee, Leonora S. Meyercord, Vice Chair of the Partnership and Real Estate Tax Committee, and Crawford Moorefield, Chair of the Energy and Natural Resources Tax Committee. The Committee on Government Submissions ("COGS") of the Tax Section of the State Bar of Texas has approved these Comments. Jeffry M. Blair, Co-Chair of COGS, reviewed these Comments. Mary A. McNulty, Past Chair of the Tax Section and member of the Past Chair Advisory Board, reviewed the Comments and made substantive suggestions on behalf of COGS.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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I. INTRODUCTION

These Comments are provided in response to Treasury's and the IRS's request for comments regarding the Proposed Regulations, proposed rules concerning the implementation of the new Centralized Audit Regime which was enacted into law on November 2, 2015 by section 1101 of the Bipartisan Budget Act of 2015, Pub. L. No. 114-74 (the "BBA"), as corrected and clarified by the Protecting Americans from Tax Hikes Act of 2015, Pub. L. 114-113, div. Q (the "PATH Act"). The BBA repeals the current rules governing partnership audits, including those enacted under the Tax Equity and Fiscal Responsibility Act ("TEFRA"), for tax years beginning after December 31, 2017. The BBA replaces those rules with a centralized audit regime that generally provides for assessment and collection of tax at the partnership level rather than the partner level. We appreciate the opportunity to comment on the Proposed Regulations.

II. ELECTION OUT FROM CENTRALIZED AUDIT REGIME AND DISREGARDED ENTITIES

Section 6221(b)[1] provides that partnerships with 100 or fewer partners may elect out of the Centralized Audit Regime ("Election Out"). For purposes of determining whether a partnership has 100 or fewer partners, partners that are individuals, domestic C corporations, foreign entities that would be treated as C corporations if they were domestic, and estates of deceased partners are counted as partners.[2] S corporations are looked through with each shareholder of an S corporation treated as a partner for purposes of meeting the 100 or fewer partners test.[3]

Section 6221(b) does not specifically address whether an entity that is disregarded as separate from its owner for federal tax purposes under existing regulations (a "DRE") would be treated as an ineligible type of partner that would cause the partnership automatically to be ineligible for the Election Out, or separately counted as an additional partner for purposes of the Election Out's 100 partner limit. However, Section 6221(b)(2)(C) provides flexibility to Treasury and the IRS to prescribe regulations allowing for additional kinds of partners not described in Section 6221(b)(1)(C) and to create rules for counting the number of partners in a manner similar to the rules for S corporations.

Under the Proposed Regulations, a partnership, a trust, a foreign entity that would not be treated as a C corporation if it were a domestic entity, "a disregarded entity described in §301.7701-2(c)(2)(i) [DRE]," a nominee or other similar person, or an estate of an individual other than a deceased partner would not be treated as an "eligible partner" for purposes of qualifying for the Election Out.[4] This would result in any partnership with one or more such ineligible partner being unable to make an Election Out. The preamble to the Proposed Regulations states that Treasury and the IRS "have declined in these proposed regulations to exercise the authority under section 6221(b)(2)(C) to expand the types of entities that are eligible partners for purposes of the election out rules or to create separate election out provisions for specific partnership structures." Treasury and the IRS gave the following reasons for this decision:

> . . . When a partnership elects out of the centralized partnership audit regime, the IRS must examine and assess tax with respect to each ultimate partner under the deficiency procedures under subchapter B of chapter 63. Enactment of TEFRA was a reaction to the complexity and burden of these deficiency procedures with respect to partnerships. The

[1] Unless otherwise indicated, all "Section" or "§" references are to the Internal Revenue Code of 1986, as amended (including amendments enacted under the BBA and the PATH Act).

[2] § 6221(b)(1)(C).

[3] *Id.* The S corporation is also required to furnish additional information with respect to each such S corporation shareholder.

[4] *See* Prop. Reg. §§ 301.6221(b)-1(b)(3)(ii) and (iii).

increasing number and complexity of partnerships since TEFRA was enacted revealed that the TEFRA procedures were inadequate for the IRS to effectively audit partnerships. The centralized partnership audit regime is intended to enhance the IRS's ability to examine partnerships, particularly large and highly tiered partnerships. If the proposed regulations broaden the scope of the election out provisions to include additional types of partners or partnership structures, the IRS will face additional administrative burden in examining those structures and partners under the deficiency rules. Comments on any potential expansion of the election out rules are particularly helpful if they address the additional burdens any such expansion would impose on the IRS and not just the decreased burden on taxpayers resulting from the suggested change.

Generally, we understand Treasury's and the IRS's concerns insofar as they relate to expansion of the Election Out to include as eligible partners entities such as partnerships and nominees. We believe the concerns regarding those entities are potentially significant and that expansion of the Election Out to include them could result in a substantial increase in the IRS's administrative burdens.

However, we respectfully disagree that allowing the Election Out for DREs would pose substantial administrative burdens for the IRS. Under existing law, DREs are generally disregarded as separate from their owners for federal tax purposes.[5] We respectfully recommend that the IRS simply look through the DRE and look at the sole owner to determine whether that owner is an eligible partner for the Election Out. As a legal matter, treatment of DREs as not separate from their owners for purposes of the Election Out would not represent an expansion of partnerships eligible for the Election Out. As a practical matter, the IRS could require a DRE to supply the applicable information with respect to the DRE's sole owner, similar to an S corporation. Any additional burden from allowing a partnership with DREs to elect out would fall on taxpayers and not on the IRS.

The IRS had previously relied on Congress's definition of the term "pass-thru partner" at former Section 6231(a)(9) in ruling that a DRE's separate existence was taken into account for purposes of determining whether a partnership was eligible for the small partnership exception under TEFRA.[6] These rules also prevented partnerships with an S corporation as a partner from qualifying for the small partnership exception.[7] Former Section 6231(a)(9) has been repealed, and S corporations are now allowed to be partners of partnerships that may make an Election Out. We respectfully recommend that Treasury and the IRS further consider whether it would be appropriate to permit partnerships with S corporation partners to be eligible for the Election Out while denying that same option to partnerships with DREs as partners. Although an S corporation may not have a partnership as a shareholder, whereas a DRE may be wholly-owned by a partnership, this difference would not result in any additional administrative burden on the

[5] *See* Treas. Reg. § 301.7701-2(c)(2)(i).

[6] *See* Rev. Rul. 2004-88, 2004-2 C.B. 165.

[7] § 6231(a)(9).

IRS. A partnership with a DRE partner that is wholly-owned by a partnership would not be eligible to make the Election Out.[8]

If partnerships with DREs as partners are categorically excluded from eligibility, the adverse effect on taxpayers would be very substantial. For more than two decades, taxpayers have relied on the check-the-box regulations for purposes of their tax planning, creating entities that they understood would be disregarded as separate from their owners for virtually all federal tax purposes. Taxpayers have relied on this treatment to provide state law liability protection while understanding that DREs would be ignored for federal income tax purposes and their owners would remain fully responsible for the federal income taxes for their portions of partnership income. If Proposed Regulations section 301.6221(b)-1(b)(3)(ii)(D) is adopted as proposed, the burden on taxpayers to reorder their affairs would likely be very substantial, resulting in a new wave of tax planning by taxpayers to undo unintended and unanticipated consequences of elections they made years ago. Moreover, the provision, as proposed, creates a potential trap for the unwary. Those who relied on the promise of Treasury Regulations section 301.7701-2(c)(2)(i) that their entity will be disregarded for federal tax purposes may be terribly surprised to find that their entity would not be disregarded under the partnership audit rules as described in an entirely separate set of regulations. This would create a difficult choice for taxpayers in having to choose between a structure that is beneficial for non-federal income tax purposes and one that would be best for federal partnership income tax audit purposes. It could also result in some partnerships refusing to admit partners who own their interests through DREs.

The Joint Committee on Taxation (the "Joint Committee") explained that Treasury and the IRS could prescribe regulations allowing partnerships with certain types of partners, including DREs, to remain eligible for the Election Out.[9] The Joint Committee included a specific example for DREs, as follows:

> For example, assume that a partner of a partnership is a disregarded entity such as a State-law limited liability company ("LLC") with only one member, a domestic corporation. Such guidance may provide that the partnership can make the election if the partnership includes (in the manner prescribed by the Secretary) a disclosure of the name and taxpayer identification number of each of the disregarded entity and the corporation that is its sole shareholder, and each of them is taken into account as if each were a statement recipient in determining whether the 100-or-fewer statements criterion is met.[10]

We agree with the Joint Committee's suggestion that DREs be disregarded for purposes of determining who is the applicable partner of the partnership with respect to the Election Out. Consequently, we respectfully recommend that Treasury and the IRS follow the approach set out by the Joint Committee and ignore a DRE's separate existence from its owner for purposes of determining whether the partnership in which it is a partner is eligible for the Election Out.

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[8] Under I.R.C. § 6221(b)(1)(C), a partnership with a partnership as a partner is not eligible to make the Election Out.

[9] Staff of Joint Comm. on Taxation, General Explanation of Tax Legislation Enacted in 2015 59-60 (Comm. Print 2016).

[10] *Id.* at 60.

However, we believe that, with regard to the 100 partner limit, it would more appropriate if the separate existence of the DRE were disregarded and only the owner of the DRE were counted for purposes of the limit. We believe this approach is appropriate because the 100 partner limit is ordinarily determined based on the number of Schedule K-1s (or equivalent) issued by the partnership and its partners.[11] There does not appear to be any federal income tax authority that would require a partnership with a DRE partner to issue separate Schedule K-1s to both the DRE and its owner.[12] Because only one Schedule K-1 is appropriately issued with respect to a DRE partner, it seems appropriate to count as only one partner for purposes of the 100 partner limit.

Although we believe that not counting a DRE is the better approach, we understand that Treasury and the IRS may feel constrained to follow the approach recommended by the Joint Committee to count both the DRE and its owner for purposes of the 100 partner limit. In that case, we believe that such an approach would still be more appropriate than the current Proposed Regulation approach of not allowing a partnership with a DRE to be eligible for the Election Out.

III. PARTNERSHIP REPRESENTATIVE

A. Partnership Representative Designation

Under the Centralized Audit Regime, a partnership designates a partnership representative (the "Partnership Representative") who is the only person that has the authority to act on behalf of the Partnership in connection with partnership audits, adjustments, assessments, and collection.[13] The Partnership Representative's authority is expansive, and the Partnership Representative's actions are binding on all former and current partners.[14] The Proposed Regulations provide that a partnership may designate as the Partnership Representative any person (including an entity) that has a substantial presence in the United States and the capacity to act.[15]

However, there is currently no provision in the Proposed Regulations or statute requiring that the designated person accept the designation as Partnership Representative. Given the importance of communication between the IRS and the Partnership Representative for an efficient and effective administrative proceeding and the expansive authority of the Partnership Representative,[16] we think it is critical that the Partnership Representative agree to serve. We recommend that the Proposed Regulations, as finalized, require the Partnership Representative to be named in the operative documents or to accept the designation. Such acceptance could be evidenced on the tax return by adding a box that the Partnership would check to confirm the

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11 §§ 6221(b)(1)(B) and 6221(b)(2)(A)(ii).

12 By contrast, an S corporation is respected as a partner of a partnership, and the partnership is required to issue a Schedule K-1 to the S corporation. Therefore, the Proposed Regulations appropriately require that both the Schedule K-1 issued to the S corporation by the partnership and the Schedule K-1s issued by the S corporation to its shareholders be counted. Prop. Reg. §§ 301.6221(b)-1(b)(2)(iii), Ex. 4.

13 § 6223(a).

14 § 6223(b).

15 Prop. Reg. § 301.6223-1(b)(2), (b)(3) and (b)(4).

16 *See* Proposed Regulations, Preamble at Explanation of Provisions, Section 4.A (recognizing that communication between the IRS and the Partnership Representative is fundamental to an efficient administrative proceeding).

named Partnership Representative agreed to serve as the Partnership Representative. If this box were not checked, the Proposed Regulations, as finalized, could allow the IRS to designate the Partnership Representative.

Having the Partnership Representative agree to serve would help avoid delays on the initiation of an audit. If the Partnership Representative has not agreed to serve, the Partnership Representative—when faced with the significant responsibilities of representing the partnership in an IRS audit that will bind both current and former partners—may be more likely to promptly resign. This could delay the audit while the partnership or IRS designates a successor.

B. Multiple Partnership Representatives in a Multi-Year Audit

The Proposed Regulations provide that the partnership must designate the Partnership Representative on the partnership's return each year, and the partnership must designate a Partnership Representative separately for each taxable year.[17] Consequently, in a multi-year audit, the partnership may have a different Partnership Representative for each year under audit, which may lead to confusion, a duplication of resources and a lack of coordination in the administrative proceeding. To improve the efficiency of a multi-year audit involving multiple Partnership Representatives, we recommend that the Proposed Regulations, as finalized, permit the IRS to require the partnership to designate one Partnership Representative to act as the Partnership Representative for all of the years under audit.[18] If the partnership fails to make such a designation following an IRS request, the IRS would be permitted to designate the Partnership Representative from those named by the partnership for the different years under audit.

C. Factors for IRS Designation of Partnership Representative

The Proposed Regulations provide that when the IRS determines that the designation of a Partnership Representative is not in effect and the partnership fails to designate a successor, the IRS may designate a Partnership Representative. Proposed Regulations section 301.6223-1(f)(5)(ii) provides that the IRS may designate any person as the Partnership Representative and indicates that in addition to other factors, the IRS will consider whether there is a suitable partner of the partnership, either from the reviewed year (as defined in Proposed Regulations section 301.6241-1(a)(8)) or at the time the partnership representation designation is made. In addition, the IRS may consider the following factors when designating a person as the partnership representative:

- The views of the partners having a majority interest in the partnership regarding the designation;
- The general knowledge of the person in tax matters and the administrative operation of the partnership;
- The person's access to the books and records of the partnership; and

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17 Prop. Reg. § 301.6223-1(c).

18 The recommendation that the Partnership Representative be named in the operative documents or accept the designation on the return may also reduce the likelihood that the partnership will designate a different Partnership Representative each year.

- Whether the person is a United States person (within the meaning of Section 7701(a)(30)).[19]

In the absence of a suitable partner from the reviewed year or at the time of the designation, this provision does not provide any real constraints on the exercise of the IRS's discretion. It does not require that the IRS ordinarily consider any specific factors, but instead provides only that the IRS **may** consider the four enumerated factors. To provide some reasonable limits on the IRS's discretion, we respectfully recommend that Proposed Regulations section 301.6223-1(f)(5)(ii) be revised as follows:

> (ii) *Factors considered when partnership representative designated by the IRS.* The IRS may designate any person to be the partnership representative. In addition to other relevant factors, the IRS will consider whether there is a suitable partner of the partnership, either from the reviewed year (as defined in §301.6241-1(a)(8)) or at the time the partnership representative designation is made. The IRS ~~may~~ <u>will ordinarily</u> consider <u>one or more of</u> the following factors when designating a person as the partnership representative:
>
> (A) The views of the partners having a majority interest in the partnership regarding the designation;
>
> (B) The general knowledge of the person in tax matters and the administrative operation of the partnership;
>
> (C) The person's access to the books and records of the partnership;
>
> (D) Whether the person is a United States person (within the meaning of section 7701(a)(30)).

IV. COMPUTATION OF THE IMPUTED UNDERPAYMENT

The Proposed Regulations provide detailed rules regarding the calculation of the imputed underpayment, and the examples illustrating these rules are very helpful. The Proposed Regulations, however, delete Example 3 that was included in section 301.6225-1(f) of the unofficial Proposed Regulations that were released in January, 2017. While we identified a math error in that example, the example was helpful in illustrating the calculation of the imputed underpayment in a situation in which an adjustment reallocates an item from one partner to another. We respectfully recommend that this example be included as corrected below.

Example 3 in the unofficial Proposed Regulations provided as follows (underline added):

> *Example 3.* Partnership has two partners, A and B. Under the partnership agreement, among other items allocated to the partners, $30 of ordinary income and $70 of depreciation are specially allocated to B for the 2019 taxable year. In an administrative proceeding with respect to Partnership's 2019 taxable year, the IRS determines that the $30 of ordinary income and $70 of depreciation should be

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19 Prop. Reg. § 301.6223-1(f)(5)(ii)(A)-(D).

reallocated from B to A. The partnership adjustment is a decrease of $30 of ordinary income (<$30> adjustment) and a decrease of $70 of depreciation ($70 adjustment) allocated to B and a corresponding increase of $30 ordinary income ($30 adjustment) and $70 of depreciation (<$70> adjustment) allocated to A. Pursuant to paragraph (d)(2)(ii) of this section, for purposes of determining the imputed underpayment, the adjustments to the distributive shares of A and B are grouped separately. The increases and decreases to depreciation are treated as decreases and increases, respectively, of ordinary income. As a result, the net $40 of income ($70 ordinary income plus <$30> ordinary income) allocated to B is the total netted partnership adjustment. The $40 increase is then multiplied by 40 percent, which results in an imputed underpayment of $28. The net decrease of income of $40 ($30 ordinary income plus <$70> ordinary income) reallocated to A is disregarded for purposes of determining the imputed underpayment. The $30 of ordinary income and the $70 of deductions reallocated to A are partnership adjustments that do not result in an imputed underpayment.

We believe that the underlined portion above contains the math mistake. As indicated in the first part of the sentence, the forty percent (40%) tax rate applies to the $40 netted amount.[20] Thus, we believe that based on the wording of the example, the imputed underpayment is $16, rather than $28. Once corrected, we believe this example would be helpful in illustrating the rules for calculating an imputed underpayment in a situation in which an adjustment reallocates an item from one partner to another.

Accordingly, we respectfully recommend that Proposed Regulations § 301.6225-1(f) be revised to include the example above as corrected to reflect the imputed underpayment as $16 rather than $28 or clarified to make it clear how the $28 figure was calculated.

V. MODIFICATION BY PARTNERS FILING AMENDED RETURNS

The Proposed Regulations provide that the IRS will not accept modification of the partnership's imputed underpayment under Section 6225(c) with respect to an amended return if the partner for whom the modification is sought would owe tax and the period of limitations for assessment with respect to that return has expired.[21] Specifically, Proposed Regulations section 301.6225-2(d)(v)(A) provides:

> (v) *Period of limitations must be open*—(A) *In general.* Except as described in paragraph (d)(2)(v)(B) [allowing modification if a refund is claimed] of this section, the IRS will not accept modification under paragraph (d)(2) of this section with respect to any amended return if the period of limitations on assessment under section 6501 with respect to the partner's taxable year for which the amended return is being filed has expired. For modification with respect to years for which a partner's period of limitations on assessment under section 6501 has expired, see §301.6225-2(d)(8) (regarding closing agreements).

[20] *See* Prop. Reg. § 301.6225-1(d)(2)(ii) (allowing for items in the reallocation grouping allocable to a partner to be placed into subgroupings and netted).

[21] Prop. Reg. §301.6225-2(d)(2)(v).

As was explained in the preamble to the Proposed Regulations, Congress expressly allowed modification with respect to amended returns for which a refund is claimed, even though the period of limitations for claiming a refund under Section 6511 has expired.[22] In contrast, Congress did not similarly provide such relief when an assessment and payment of tax is involved and the period of limitations for assessment for the partner in question has expired.

Consequently, modification procedures to reduce the amount of imputed tax that would be owed will not be available with respect to partners whose assessment statutes of limitation have expired. For this reason the preamble cautions, "[a]ny partner that files an amended return for modification purposes and is required to make a payment of any kind with that amended return must do so prior to the expiration of the period of limitations under section 6501 for the modification year(s)."[23] Unfortunately, partners would have little control over when they can file amended returns for modification purposes, because the timing of such filings would depend upon the timing of the IRS's determination of the imputed underpayment.

In the preamble, Treasury and the IRS suggest one way to ameliorate the problem, as follows:

> . . . Nothing in the proposed regulations prevents partners from signing an extension of the period of limitations for partnership adjustments at the time the IRS initiates the partnership administrative proceeding or at any other time prior to the expiration of the period of limitations under section 6501. The IRS recognizes that securing such extensions may not be possible in all cases, but doing so may be an option for certain partners and partnerships.[24]

This approach will prove workable only if the IRS in some manner periodically solicits consents to extend the period of limitations for assessment with respect to the partners. Taxpayers do not control the IRS's solicitation of consent forms. In fact, a search for Form 872 on the IRS website does not yield the standard IRS consent forms used for extending the period of limitations. Consequently, placing the burden on the partners to extend the period of limitations for assessment is not a workable solution.

If a partner's period of limitations for assessment has expired, the alternatives for obtaining relief seem speculative or inadequate. The preamble suggests that "[a] partner may, for example, be able to enter into a closing agreement that allows for treatment similar to an amended return and to make a payment on behalf of the partnership's liability in recognition of what the partner would have filed and paid if the partner's assessment period had not already expired."[25] It is not at all clear whether and why the IRS would agree to this procedure when a partner's period of limitations for assessment has expired. Alternatively, the preamble suggests that "partners and the partnership may choose to make other arrangements where the partner pays the imputed underpayment on behalf of the partnership outside of the modification

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22 *See* Proposed Regulations, Preamble, Background, Section 2.E; *see also* §6225(c)(2)(A)(i) (which allows such modifications "notwithstanding section 6511").

23 Proposed Regulations, Preamble, Explanation of Provisions, Section 5.D.i..

24 *Id.*

25 *Id.*

procedures."[26] While this may provide a mechanism for a partner, rather than the partnership, to pay a share of the imputed underpayment, it seems unlikely that a partner could secure an agreement from the partnership to pay anything less than his or her share of the full amount of the imputed underpayment when the partner's assessment period of limitations has expired and made modification unavailable.

Consequently, we believe the best approach would be to try from the outset to avoid having the problem occur. We therefore respectfully recommend that the Proposed Regulations include a requirement that, at the time the IRS initiates the partnership administrative proceeding and at such times as the IRS solicits consents to extend the partnership's period of limitations pursuant to Section 6235(b), the IRS provide the Partnership Representative with the consent form for extending the period of limitations for assessment with respect to partners, together with contact information for a person to contact at the IRS regarding partner-level extensions. If the Partnership Representative provides the form and contact information to the partners, a partner seeking to extend the period of limitations could then complete the form and provide it to the contact person at the IRS.

VI. CONSEQUENCES OF FAILURE TO FURNISH STATEMENTS IN PUSH-OUT ELECTION

Under Section 6226 and Proposed Regulations section 301.6226-2, a partnership that makes a push-out election under Section 6226 must furnish statements to the reviewed year partners with each partner's share of partnership adjustments. Proposed Regulations section 301.6226-2(b) requires the partnership to mail the statement to the current or last known address of the partner and—if a statement is returned—undertake reasonable diligence to identify the reviewed year partner's correct address.

The Proposed Regulations do not, however, address the consequences of the partnership's failure to properly furnish the required statement to a partner. We respectfully recommend that the Proposed Regulations clarify that, in such a situation, the push-out election is still generally effective with respect to the other reviewed year partners, but the partnership is liable for the tax attributable to the partner to which the partnership failed to properly furnish the statement. This will protect the IRS's ability to collect with respect to the incorrectly furnished statement while preserving the push-out election with respect to the other partners. It would be administratively impractical for the failure to furnish a statement to invalidate the entire push-out election because the partners that received the statement may have already filed amended returns and paid the tax due before the mistake is realized.

This change can be accomplished by adding the following new sentence to the end of Proposed Regulations section 301.6226-1(c)(2): "If a partnership fails to properly furnish a statement to a reviewed year partner in accordance with §301.6226-2, the election is invalid only with respect to the reviewed year partner to which the partnership failed to properly furnish the statement."

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[26] Proposed Regulations, Preamble, Explanation of Provisions, Section 5.F.

VII. STATUTE OF LIMITATIONS FOR ADJUSTMENT

Section 6235(a) provides the limitations period within which the Service must make an adjustment under the Centralized Audit Regime.[27] Section 6235(a) provides as follows:

> (a) IN GENERAL.—Except as otherwise provided in this section, no adjustment under this subpart for any partnership taxable year may be made after the later of—
>
> (1) the date which is 3 years after the latest of—
>
> (A) the date on which the partnership return for such taxable year was filed,
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> (B) the return due date for the taxable year, or
>
> (C) the date on which the partnership filed an administrative adjustment request with respect to such year under section 6227, or
>
> (2) in the case of any modification of an imputed underpayment under section 6225(c), the date that is 270 days (plus the number of days of any extension consented to by the Secretary under paragraph (7) thereof) after the date on which everything required to be submitted to the Secretary pursuant to such section is so submitted, or
>
> (3) in the case of any notice of a proposed partnership adjustment under section 6231(a)(2), the date that is 330 days (plus the number of days of any extension consented to by the Secretary under section 6225(c)(7) after the date of such notice.

The periods under Section 6235(a)(2) and (a)(3) are measured from the date the notice of proposed partnership adjustment ("NOPPA") is issued. The BBA, PATH Act and Proposed Regulations do not address the time period during which a NOPPA must be issued. Therefore, Section 6235(a)(2) and (a)(3) imply that the IRS could issue a NOPPA to revive an otherwise closed statute of limitations. That is, even if the NOPPA was issued more than three years after the return was due or filed, the IRS will have up to 540 days under subsection (a)(2)[28] or 330 days under subsection (a)(3) to issue an FPA. This would make the statute of limitations period virtually unlimited for partnership adjustments made under the Centralized Audit Regime.

An unlimited statute of limitations period would be contrary to the general three-year limitations period in the Code[29] and create a significant incentive for partners to reorganize partnership ownership to be eligible to elect out of the Centralized Audit Regime. This would likely reduce the partnerships subject to the Centralized Audit Regime and increase the partnerships that the IRS must audit and assess tax at the partner level pursuant to deficiency procedures under subchapter B of chapter 63. As the preamble recognizes, such procedures are complex and burdensome.

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[27] *See also* § 6232(b) (no assessment may be made before the 90th day after the notice of final partnership adjustment ("FPA") is mailed and—if a petition is filed in the Tax Court—the decision of the court has become final.)

[28] Under § 6225(c)(6), the partnership has 270 days after the date the NOPPA is issued to submit documentation to reduce the imputed underpayment. Therefore, Section 6235(a)(2) allows the Service 540 days after the NOPPA is issued to issue an FPA.

[29] *See, e.g.*, § 6501(a).

In addition, an unlimited statute of limitations would conflict with long-standing Supreme Court case law. In *Rothensies v. Electric Storage Battery Co.*, the Supreme Court recognized that statutes of limitations are "an almost indispensable element of fairness as well as of practical administration of income tax policy" because otherwise taxpayers would be required to "stand ready forever and a day to produce vouchers, prove events, establish values and recall details of all that goes into an income tax contest."[30] Congress could not have intended to depart from such a well-established principle—particularly without any legislative history explaining the reason for such a dramatic departure.

Therefore, a logical inference is that the NOPPA must be issued within the three-year period in Section 6235(a)(1). That is, the NOPPA must be issued within three years of the latest of the date the partnership return was filed, the date the return was due or the date the partnership filed an administrative adjustment request. Accordingly, we respectfully recommend that the Proposed Regulations clarify the NOPPA must be issued within the three-year period specified in Section 6235(a)(1).[31] This would protect the general three-year statute of limitations, while allowing for an extension for the partnership to submit and the Service to process documentation to reduce the imputed underpayment.

VIII. APPLICATION TO CONSTRUCTIVE PARTNERSHIPS

The preamble to the Proposed Regulations provides that "the IRS intends to carefully scrutinize whether two or more partnerships that have elected out should be recast under existing judicial doctrines and general federal tax principles as having formed one or more constructive or de facto partnerships for federal income tax purposes."[32] In such a case, the constructive or de facto partnership would be subject to the Centralized Audit Regime. The rules do not address, however, how the tax will be collected from a constructive partnership, which does not have any assets since it is not a juridical entity for state law purposes.[33]

We respectfully recommend that the Proposed Regulations be revised to clarify that a constructive partnership will be treated as if it made a push-out election under Section 6226. This would ensure that the federal income tax resulting from an audit adjustment with respect to a constructive partnership would be assessed upon and collected from the parties that own (for state law purposes) the assets for which the tax deficiency originated.

This change can be accomplished by revising the definition of when a partnership "ceases to exist" in Proposed Regulations section 301.6241-3(b)(2) to include a constructive or de facto partnership. Under that section of the Proposed Regulations, the IRS treats a partnership that "ceases to exist" (which includes a partnership that lacks the ability to pay the tax) as if it made a

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[30] 329 U.S. 296, 300 (1946).

[31] Comments have also suggested statutory fixes to this statute of limitations issue. For example, the New York State Bar Association suggested that the statute be amended to require a preliminary FPA or final NOPPA be issued in the three-year period in Section 6235(a)(1). *See* NYS Bar Ass'n Tax Section, "Report on the Partnership Audit Rules of the Bipartisan Budget Act of 2015," Report No. 1347 (May 25, 2016).

[32] Proposed Regulations, Preamble, Explanation of Provisions, Section 2.C.

[33] This is of particular relevance to the oil and gas industry because a joint operating agreement between co-owners of oil and gas properties generally creates a constructive tax partnership for federal income tax purposes unless the partnership elects out. *See* §§ 761(a) and 7701(a)(2).

push-out election under Section 6226. This change would be a clarification rather than a substantive change because a constructive partnership would likely be treated as ceasing to exist because it does not have the ability to pay the tax (since it does not have any assets).

IX. CLARIFICATION OF DEFINITION OF PARTNERSHIP AS PASS-THROUGH PARTNER

For purposes of the Centralized Audit Regime, Section 6241(1) provides that "the term 'partnership' means any partnership required to file a return under Section 6031(a)." Section 6031(a) refers to the Section 761(a) definition of partnership which excludes certain eligible joint ventures that have elected out of subchapter K. The only circumstance in which a partnership that has elected out of subchapter K would file a partnership return is to make the election out. Proposed Regulations section 301.6241-5(c)(2) addresses this situation by providing that the Centralized Audit Regime does not apply to any partnership that files a partnership return for the sole purpose of making an election out of subchapter K. The preamble explains that "[u]nder proposed §301.6241-5(c)(2), the provisions of subchapter C of chapter 63 do not apply to taxable years for which a partnership return is filed solely to make an election described in section 761(a) (election out of subchapter K of chapter 1 for certain unincorporated organizations)."[34] Hence, it is clear that the Centralized Audit Regime does not apply to joint ventures that have elected out of subchapter K under Section 761(a).

However, Proposed Regulations section 301.6241-1(a)(5) does not exclude a partnership that has elected out of subchapter K from the definition of a "pass-through partner." Proposed Regulations section 301.6241-1(a)(5) defines a pass-through partner as including "a partnership as described in §301.7701-2(c)(1)" of the Treasury Regulations, which is arguably far broader than the definition of "partnership" in Section 6241(1). Treasury Regulations section 301.7701-2(c)(1) provides that "[t]he term *partnership* means a business entity that is not a corporation under paragraph (b) of this section and that has at least two members." It does not provide an exception for a partnership that has elected out of subchapter K under Section 761(a).

This definitional issue is relevant to oil and gas, mineral, and timber joint ventures. This issue is especially important in states such as Texas that have significant oil and gas, mineral and timber industries, where joint ventures frequently elect out of subchapter K.

Accordingly, we respectfully recommend that Proposed Regulations section 301.6241-1(a)(5) be revised to be consistent with the definition of "partnership" in Section 6241(1). Specifically, we recommend that Proposed Regulations section 301.6241-1(a)(5) be revised to eliminate the reference to the regulations under Section 7701 and to instead refer to "a partnership required to file a return under section 6031(a)."

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[34] Proposed Regulations, Preamble, Explanation of Provisions, Section 8.F.

TAX SECTION
State Bar of Texas

August 7, 2017

Via e-mail: Notice.Comments@irscounsel.treas.gov
and FedEx Overnight Delivery

Internal Revenue Service
CC:PA:LPD:PR (Notice 2017-38)

Courier's Desk
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

RE: Comments in Response to Notice 2017-38 Regarding Proposed Regulations Under Sections 2704 and 6035

Dear Ladies and Gentlemen:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Department of the Treasury ("Treasury") and Internal Revenue Service (the "Service") in the Notice 2017-38, Implementation of Executive Order 13789 (Identifying and Reducing Tax Regulatory Burdens) issued on June 14, 2017 (the "Notice").

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW. THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED

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BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend the Treasury and Service for the time and thought that has been put into preparing the Proposed Regulations, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Stephanie M. Schroepfer

Stephanie M. Schroepfer, Chair
State Bar of Texas, Tax Section

SS/lab
Enclosure

COMMENTS ON NOTICE 2017-38
IMPLEMENTATION OF EXECUTIVE ORDER 13789

These comments on the Notice (the "Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafters of these Comments were Celeste C. Lawton, Co-Chair of the Estate and Gift Tax Committee, Laurel Stephenson, Co-Chair of the Estate and Gift Tax Committee, and Carol G. Warley, Vice-Chair of the Estate and Gift Tax Committee. Henry Talavera, Co-Chair of the Committee on Government Submissions (COGS) of the Tax Section of the State Bar of Texas has approved these Comments on behalf of COGS. Lora G. Davis, CLE Co-Chair of the Tax Section, reviewed the Comments and made substantive suggestions on behalf of COGS.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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I. INTRODUCTION

These Comments are provided in response to Treasury and the Service's request for comments regarding whether certain regulations described in the Notice should be rescinded or modified, and in the latter case, how the regulations should be modified in order to reduce burdens and complexity. We appreciate the opportunity to comment on the Proposed Regulations.

II. SUMMARY

1. We respectfully recommend that the Service either rescind or modify the Proposed Regulations under section 2704 of the Internal Revenue Code of 1986, as amended ("Code") in accordance with previous comments submitted by the Tax Section of the State Bar of Texas.

2. We respectfully recommend that the Service revise the Proposed Regulations under section 6305 of the Code as follows:

(a) Permit taxpayers to resubmit to the Service (at the same address the Form 8971 is to be submitted) the applicable estate tax return schedules that disclose information relevant to ascertaining estate tax value as an attachment to Schedule(s) A to Form 8971 in certain circumstances as discussed below.

(b) If capital gain or capital loss is recognized by the estate because property is distributed to a beneficiary in kind to satisfy a pecuniary bequest, we respectfully request that the executor not be required to report such property on a Schedule A to such beneficiary.

III. PROPOSED REGULATIONS UNDER SECTION 2704 OF THE CODE ON RESTRICTIONS ON LIQUIDATION OF AN INTEREST FOR ESTATE, GIFT AND GENERATION-SKIPPING TRANSFER TAXES (REG-163113-02; 81 FED. REG. 51413 (OCT. 4, 2016)) ("Proposed 2704 Regulations")

The Proposed 2704 Regulations regarding Section 2704 set forth rules concerning the valuation of interests in certain business entities for transfer tax purposes, specifically with respect to the treatment of certain lapsing rights and liquidation restrictions in determining the value of intra-family transfers of interests in such entities. We believe that the Proposed 2704 Regulations impose an undue financial burden on the U.S. taxpayer by disregarding certain restrictions that are placed, pursuant to local law or the terms of the governing instrument, on interests held by a taxpayer in certain family-owned entities. We also believe that the Proposed 2704 Regulations may have exceeded Congressional authority by broadening the family attribution principles beyond what Congress intended, as explained in the comments that we previously submitted regarding these issues in a letter dated November 2, 2016, which comments are attached to this letter and incorporated by reference ("Original Submission"). We respectfully request that the Proposed 2704 Regulations be rescinded or, at a minimum, modified in accordance with our Original Submission.

IV. PROPOSED REGULATIONS UNDER SECTION 6035 OF THE CODE REGARDING BASIS REPORTING BETWEEN ESTATE AND PERSON ACQUIRING PROPERTY FROM DECEDENT (REG-127923-15; 81 Fed. Reg. 11486 (Mar. 4, 2016)) ("Proposed 6035 Regulations")

We respectfully request that Treasury also consider the undue financial burden imposed on U.S. taxpayers by the Proposed 6035 Regulations as further explained below. Section 6035(a)(1) requires an executor of an estate that is required to file an estate tax return to provide the Service and each beneficiary "acquiring any interest" in the property included on the estate tax return a statement (i.e., Schedule A to Form 8971) identifying the value of the "interest in such property." Proposed 6035 Regulation § 1.6035-1(c)(3) provides that if an executor has not determined which assets a beneficiary will receive by the date the Schedule(s) A and Form 8971 are to be provided to the Service and each beneficiary, the executor must list on the beneficiary's Schedule A all items of property "that the executor could use to satisfy that beneficiary's interest." The Proposed 6035 Regulations provide exceptions for certain types of property that do not need to be reported on Schedule A, including but not limited to, "[p]roperty sold, exchanged, or otherwise disposed of (and therefore not distributed to a beneficiary) by the estate in a transaction in which capital gain or loss is recognized."

We believe the Proposed Regulations impose an undue financial burden on U.S. taxpayers by requiring the taxpayers subject to the Proposed Regulations to resubmit information to the Service that it has already received, in a manner that often requires substantial time and expense to the taxpayer. Currently, executors of estates required to file Form 8971 and Schedule(s) A must include a detailed listing of each item on the Schedule A and are prohibited from attaching the estate tax return to Schedule A in lieu of this detailed reporting. A significant portion of this additional taxpayer burden will be avoided if the taxpayer is allowed to resubmit to the Service (at the same address the Form 8971 is to be submitted) the applicable estate tax return schedules that disclose information relevant to ascertaining estate tax value as an attachment to Schedule(s) A to Form 8971.

The burden on U.S. taxpayers is especially evident when the executor, who is responsible for filing the Form 8971 and Schedule(s) A, is the only person to whom one or more Schedule(s) A must be provided and the estate tax return provides no less information than that which is required to be reported on the applicable Schedule A. For example, it is common for a decedent to leave all of his or her property outright to the surviving spouse or in a trust for the surviving spouse and to also name the surviving spouse as both executor of the decedent's estate and the trustee of any trust created for the surviving spouse. It is also common for such trusts for the surviving spouse to be unfunded at the time the Schedules A and Form 8971 are due to the Service and each beneficiary.

In such case, the executor/beneficiary would prepare a Schedule A:

(i) Listing the date of death value of any property passing outright to the surviving spouse, which would consist of no less information than the information already included on Schedule M of the estate tax return under "All other property"; and

(ii) For each trust that is a beneficiary, which would consist of all other property listed in the estate tax return not reported on the Schedule A described in (i) above.

Requiring the executor/beneficiary to prepare Schedules A and Form 8971 in accordance with the Proposed 6035 Regulations in these circumstances is an unnecessary expense and use of time that could be eliminated if the executor could instead use the estate tax return schedules to report that information as discussed above.

We believe the Proposed 6035 Regulations also impose an undue financial burden on U.S. taxpayers in the event that property is distributed in kind to satisfy a pecuniary bequest using the date of distribution value. If property is distributed in kind to satisfy a pecuniary bequest, the estate will recognize a taxable gain to the extent that the fair market value of the property on the date it is distributed to satisfy the pecuniary bequest exceeds the estate tax value of the property (i.e., the value of the property that is reported on Schedule A). As a result of the estate recognizing the gain on such distribution, the beneficiary's basis in the property is equal to the fair market value of the property on the date it is distributed to the beneficiary.

Nevertheless, the Proposed Regulations require the executor to deliver to the beneficiary a Schedule A reporting estate tax value, which is completely irrelevant to the beneficiary and, in fact, could be interpreted by the beneficiary in a manner that may the lead the beneficiary into incorrectly reporting basis at a later time because of the misleading nature of Schedule A. Although the Proposed Regulations provide that property disposed of by the estate in a transaction in which capital gain is recognized does not need to be reported on Schedule A, this exception excludes property that is distributed to the beneficiary. If capital gain is recognized by the estate because property is distributed to a beneficiary in kind to satisfy a pecuniary bequest, the beneficiary's basis in the property is equal to the date of distribution value, rather than the estate tax value. Therefore, the executor should not be required to provide a Schedule A to the beneficiary that necessarily reports the date of death value of such property because providing such Schedule A to the beneficiary and Service does not achieve the purpose of Schedule A, which is to provide the beneficiary and Service with the initial basis of any property received by such beneficiary. Requiring the Schedule A to be prepared with this irrelevant information and delivered to such a beneficiary is an unnecessary expense and an undue financial burden on the U.S. taxpayer. Similar concerns would arise in the funding of a pecuniary bequest with loss assets or with assets that result in a gain or loss that is not capital in nature.

TAX SECTION
State Bar of Texas

November 2, 2016

Via Federal eRulemaking Portal at www.regulations.gov

CC:PA:LPD:PR (REG-163113-02)
Room 5203
Internal Revenue Service
POB 7604
Ben Franklin Station
Washington, DC 20044

RE: Comments on Proposed Regulations Regarding Estate, Gift, and Generation-Skipping Transfer Taxes; Restrictions on Liquidation of an Interest

Dear Ladies and Gentlemen:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Department of Treasury ("Treasury") and Internal Revenue Service ("IRS") in the Notice of Proposed Rulemaking (REG-163113-02) issued on August 4, 2016 (the "Proposed Regulations"). The Proposed Regulations provide rules concerning the valuation of interests in certain business entities for estate, gift, and generation-skipping transfer tax purposes, specifically including the treatment of certain lapsing rights and liquidation restrictions in determining the value of intra-family transfers of interests in corporations, partnerships, and other entities.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS.

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THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW. THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend Treasury and the IRS for the time and thought that has been put into preparing the Proposed Regulations, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

David E. Colmenero, Chair
State Bar of Texas, Tax Section

COMMENTS ON PROPOSED REGULATIONS REGARDING ESTATE, GIFT, AND GENERATION-SKIPPING TRANSFER TAXES; RESTRICTIONS ON LIQUIDATION OF AN INTEREST

These comments on the Proposed Regulations ("Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafters of these Comments were Celeste C. Lawton, Co-Chair of the Estate and Gift Tax Committee, Laurel Stephenson, Co-Chair of the Estate and Gift Tax Committee, Matthew S. Beard, Vice-Chair of the Estate and Gift Tax Committee, and Carol Warley, Vice-Chair of the Estate and Gift Tax Committee. The Committee on Government Submissions (COGS) of the Tax Section of the State Bar of Texas has approved these Comments. Ira. A. Lipstet, Co-Chair of COGS, reviewed these Comments. Lora G. Davis, a current member of the Tax Section Council, and Melissa Willms, a former member of the Tax Section Council, also reviewed the Comments and made substantive suggestions on behalf of COGS.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: November 2, 2016

I. INTRODUCTION

These Comments are in response to the Proposed Regulations regarding the rules concerning the valuation of interests in certain business entities for estate, gift, and generation-skipping transfer tax purposes, specifically with respect to the treatment of certain lapsing rights and liquidation restrictions in determining the value of intra-family transfers of interests in corporations, partnerships, and other entities.

We recognize the time and thoughtful work invested by Treasury and the IRS in preparing the Proposed Regulations and the accompanying explanatory preamble to the Proposed Regulations (the "Preamble"). It is our intent to present items for consideration that may help support Treasury and the IRS to provide clear regulatory guidance.

For ease of discussion, we have opted to address our concerns with regard to the Proposed Regulations in a limited partnership context. However, we have identical concerns with regard to the application of the Proposed Regulations in corresponding corporate and limited liability company contexts.

II. COMMENTS REGARDING PROPOSED REGULATIONS UNDER CODE[1] § 2704

A. Interaction of Proposed Regulations with Code § 1014(f)

Code § 1014(f) provides that the initial basis of certain property acquired from a decedent "shall not exceed" its final value determined for estate tax purposes (or as otherwise reflected on Schedule(s) A to an IRS Form 8971). However, the Proposed Regulations expressly apply only "for purposes of subtitle B (relating to estate, gift and generation-skipping transfer taxes)" and not for income tax purposes. Technically, it appears that the IRS could argue pursuant to Code § 1014(a) that an interest acquired from a decedent in an entity described in Code § 2704 should have an initial income tax basis equal to its fair market value as of the decedent's date of death and not the estate tax value resulting from disregarding, pursuant to Code § 2704 and the Proposed Regulations, lapsing rights and liquidation restrictions that are otherwise relevant in establishing the interest's fair market value.

We believe the IRS and Treasury have no intention of taking this position, given that they clearly state in the preamble to Prop. Reg. § 1.1014-10 that Code § 1014(f) is intended to ensure <u>consistency</u> between the income tax basis of property acquired from a decedent and its estate tax value. Accordingly, we respectfully request the IRS and Treasury clarify that lapsing rights and liquidation restrictions disregarded pursuant to Code § 2704 and the Proposed Regulations for establishing the estate tax value of an interest acquired from a decedent in an entity described in Code § 2704 are also to be disregarded in establishing its income tax basis so that its initial basis

[1] All references herein to the "Code §" or "Section" are to the Internal Revenue Code of 1986, as amended, and all references to "Treas. Reg. §" and "Prop. Reg. §" are to the current and the proposed regulations promulgated thereunder, respectively.

will be equivalent to its final value determined for estate tax purposes (or as otherwise reflected in a Form 8971 and accompanying Schedule A).

We recognize that the suggested clarification may be more appropriate in conjunction with Prop. Reg. § 1.1014-10, particularly in light of an arguably similar need for clarity with regard to the impact of Code § 2703 and its regulations on the valuation, for both estate tax and income tax basis purposes, of entity interests transferred by a decedent. Consequently, we respectively request clarification and defer to the IRS in determining the manner in which this clarification may be best addressed.

B. Three-Year "Inclusion Window" Provided by Prop. Reg. § 25.2704-1(c)(1)

1. Recommended Alternative to Proposed Three-Year Inclusion Window

Currently, Treas. Reg. § 25.2704-1(c)(1) provides an exception to Code § 2704(a) for a transfer of an interest in an entity that results in a lapse of a liquidation right, as long as the rights associated with the transferred interest are not restricted or eliminated, although the transferor's loss of an ability to compel the entity to acquire a retained subordinate interest will be treated as a lapse with regard to it (the "Current Exception"). Prop. Reg. § 25.2704-1(c)(1) narrows the Current Exception to apply only to a transfer "occurring" more than three years prior to the transferor's death but also expands the exception to cover a lapse of a voting right associated with such a transfer (the "Proposed Narrowed Exception"). Conversely, a lapse of a voting or liquidation right resulting from a transfer within three years of the transferor's death will be treated as a lapse occurring at the transferor's death, includible in the transferor's gross estate pursuant to Code § 2704(a). These changes result in a potential three-year "inclusion window."

We do not believe that an inclusion window is appropriate. However, we believe that if one is to be adopted, it should more precisely address the concerns with "deathbed" transfers noted by the IRS and Treasury in the Preamble. We understand the practical benefits of incorporating a bright-line test to address the perceived abuses of deathbed transfers that are motivated solely by a desire to avoid inclusion of a controlling interest in a family entity in the transferor's estate for estate tax purposes. However, a strict application of the proposed three-year inclusion window will invariably produce a punitive tax result for a transferor who dies unexpectedly after transferring an entity interest without any "deathbed" motivations.

We propose instead that a lapse of a voting or liquidation right resulting from a gift be treated as occurring at the transferor's death only if he or she was "terminally ill" at the time of the gift, as determined in accordance with Treas. Reg. §§ 1.7520-3(b)(3), 20.7520-3(b)(3), and 25.7520-3(b)(3). Admittedly, an adoption of the "terminally ill" test will not provide in many instances the bright-line result otherwise achievable with the proposed three-year inclusion window. However, the "terminally ill" standard provides a workable and balanced approach to addressing the IRS's and Treasury's concerns with abusive deathbed transfers while avoiding penalizing transferors who are engaging in lifetime planning without deathbed objectives but die unexpectedly within a relatively short time thereafter.

2. Recommended Clarity on Effective Date of Three-Year Inclusion Window, if Retained

Prop. Reg. § 25.2704-4(b)(1) provides that Prop. Reg. § 25.2704-1(c)(1) will only apply to lapses of rights created after October 8, 1990 occurring on or after the date the Proposed Regulations are published as final in the Federal Register (the "Effective Date"). If despite our recommendation the three-year inclusion window is retained, it is unclear how Prop. Reg. § 25.2704-1(c)(1) will apply if an interest is transferred prior to the Effective Date but the transferor dies after the Effective Date and within three years of the transfer. Arguably, a lapse otherwise ignored at the time of the transfer prior to the Effective Date could ultimately be deemed to have occurred upon the transferor's death after the Effective Date, causing the value of the asset attributable to the lapse to be included in the transferor's estate for estate tax purposes.

Treasury and the IRS have historically provided effective dates for proposed regulations based in part upon their appreciation of planners' duties to their clients and the need to counsel them on the risks associated with different planning techniques based upon laws in effect at the time those techniques are implemented. We accordingly believe Prop. Reg. § 25.2704-1(c)(1) is intended to apply solely to lapses of voting or liquidation rights associated with lapses actually occurring after the Effective Date. If that belief is correct, then we propose that the last sentence of Prop. Reg. § 25.2704-1(c)(1) be revised to include the underlined text as follows: "The lapse of a voting or liquidation right as a result of the transfer of an interest after the Effective Date set forth in § 25.2704-4(b)(1) and within three years of the transferor's death is treated as a lapse occurring on the transferor's date of death, includible in the gross estate pursuant to section 2704(a)."

3. Recommended Clarity on Valuation of Lapse Deemed to Occur at Death

We would also appreciate guidance with regard to the valuation of the voting or liquidation right deemed to have lapsed on the transferor's death pursuant to Prop. Reg. § 25.2704-1(c)(1) (the "phantom asset"). The Preamble makes it clear that Prop. Reg. § 25.2704-1(c)(1) is intended to address "deathbed" transfers designed to avoid estate taxation of a controlling interest. Given that objective, it appears that inclusion of the value of the phantom asset in the transferor's estate is intended to recapture the discounts otherwise properly applied in valuing both the retained interest and the transferred interest. Based upon this premise, it seems that the phantom asset is properly valued as the excess of (i) the value (as of the decedent's date of death) of the transferred and retained interests (both deemed owned at that point by the decedent), determined as though the liquidation and/or voting rights were non-lapsing over (ii) the value (as of the decedent's date of death) of the transferred and retained interests immediately after the lapse(s) that is deemed to have occurred, with the transferred and retained interests valued as though they were includible in the decedent's gross estate for estate tax purposes, but not aggregated for purposes of determining the value of each interest. We would appreciate regulatory guidance confirming that this is the proper approach for valuing the "phantom asset."

We would also appreciate guidance with regard to the manner in which the "applicable restriction" and "disregarded restriction" rules will be applied, or not applied, in the event that Prop. Reg. § 25.2704-1(c)(1) requires the inclusion of the "phantom asset," so that a double taxation of value is avoided.

C. Determination of Minimum Value

1. Recommended Determination if Entity Holds Operating Business or Other Illiquid Assets

We would appreciate clarity with regard to the manner in which the "minimum value" for an interest in a family-controlled entity is to be determined in certain circumstances. Prop. Reg. § 25.2704-3(b)(ii) defines "minimum value" as an interest's share of the entity's net value as of the date of liquidation or redemption. As a general rule, an entity's net value will be equal to the fair market value of its property reduced by its outstanding obligations that would meet the deductibility standard of Code § 2053 if they were claims against an estate (a "Net Asset Value"). If an entity holds an operating business, Prop. Reg. § 25.2704-3(b)(ii) directs that its net value may be appropriately determined by also considering additional factors such as prospective earning capacity, dividend-paying capacity, and goodwill.

An interest's minimum value is effectively calculated based upon its holder's deemed ownership of a proportionate share of the entity's underlying assets (if assigned a Net Asset Value) or its operating business (if appropriately valued by consideration of the expanded list of factors). Given that, we request that if an interest's minimum value is in part derived from a proportionate share of an illiquid interest owned by an entity (e.g., real estate or an operating business) then that interest's value is to be determined by also taking into consideration any valuation discounts that would be appropriately considered in valuing an undivided interest held directly in such an illiquid interest.

For an example of why this proposed modification is suggested, assume that family members A, B, C, and D each own outright a 25% fractional interest in real property with a fair market value of $1,000,000. By its very nature, the interest each of A, B, C, and D owns in the real property is not worth $250,000. Instead, the value of each person's interest should take into account discounts for lack of control and lack of marketability and consequently be valued at some amount less than $250,000.

Further assume that A, B, C, and D transfer their interests in the real property to an entity, resulting in the entity owning the real property in its entirety. Thus, the minimum value of each individual's interest in the entity is $250,000, or $1,000,000 (the property's fair market value) multiplied by 25% (each individual's interest in the property). Pursuant to Prop. Reg. § 25.2704-3(b)(1)(ii), the minimum value of each person's interest is deemed to be $250,000 upon contribution of the property to the entity. We believe that the Proposed Regulations in this regard unduly penalize for transfer tax purposes individuals who include restrictions in business arrangements to secure creditor protections and other nontax benefits provided by owning real estate and operating businesses via an entity rather than co-owning those assets directly.

Thus, we respectfully request that Treasury and the IRS revise the Proposed Regulations to provide a look-through rule in the following suggested new last sentence to Prop. Reg. § 25.2704-3(b)(1)(ii): "Notwithstanding the preceding, if the entity holds an operating business, real estate, or other property with regard to which the value of an interest therein would typically be affected by the degree of control of such business or property that interest represents (an "Illiquid Asset"), then the "minimum value" of an interest in such entity shall be equal to (i) the fair market value, as of the date of liquidation or redemption, of such interest's share of the property held by the entity (as determined pursuant to section 2031 or 2512 and the applicable regulations), provided that any value attributable to such interest's share of an Illiquid Asset shall be determined by taking into consideration any discounts that would otherwise be appropriately applied in establishing the value of an undivided interest in such Illiquid Asset if it were held directly by an individual, reduced by (ii) such interest's proportionate share of the outstanding obligations of the entity meeting the criteria set forth above, if the net value of the entity is determined based upon its Net Asset Value."

2. Requested Clarity in Establishing Minimum Value of Interest in a Parent Entity Holding an Interest in a Subsidiary with an Operating Business

The Proposed Regulations are unclear regarding the appropriate method of valuing an operating business for purposes of determining minimum value in certain circumstances. The Preamble states that for purposes of determining minimum value, "if the entity holds an operating business, the rules of §20.2031-2(f)(2) or 20.2031-3 apply in the case of a testamentary transfer and the rules of §25.2512-2(f)(2) or 25.2512-3 apply in the case of an inter vivos transfer." Those provisions direct that the valuation of an interest in an operating business involves more than simply valuing its assets and netting its obligations against the total asset value. It requires consideration of factors such as its prospective earning capacity, dividend-paying capacity, and goodwill. It is unclear whether those valuation rules are to be applied only when a parent entity conducts an operating business or whether they also apply in determining the value of a parent entity's interest in a subsidiary entity that conducts an operating business.

The Preamble and Prop. Reg. § 25.2704-3(b)(ii) initially seem to suggest that for purposes of determining minimum value, the fair market value of an operating business held via a subsidiary should be valued by considering the expanded list of factors for consideration outlined in Treas. Reg. §§ 20.2031-2(f)(2), 20.2031-3, 25.2512-2(f)(2) and 25.2512-3. However, the last sentence of Prop. Reg. § 25.2704-3(b)(ii) provides that if the property held by the entity directly or indirectly includes an interest in another entity (which could be an operating business) with regard to which transfers by the transferor would trigger an application of Code § 2704(b), the parent entity will be treated as owning a share of the property held by the other entity "determined and valued in accordance with the provisions of section 2704(b) and the regulations thereunder." It is therefore not entirely clear if the minimum value of a parent entity's interest in an operating business held via a subsidiary entity should be based strictly on the value of the operating business's underlying property in accordance with the last sentence of Prop. Reg. § 25.2704-3(b)(ii) or whether its value should be determined after valuing the subsidiary based upon a consideration of the expanded list of additional factors referred to above.

We respectfully request that Treasury and the IRS clarify which of the preceding interpretations is the intended result under the Proposed Regulations and provide examples that would clearly identify how minimum value should be determined with respect to operating businesses held by a family-controlled entity via a subsidiary entity.

D. Recommended Clarity on Existence of "Put Right"

We appreciate the assurances provided by representatives of Treasury and the IRS that the Proposed Regulations are not to be interpreted as imputing a "put right" to holders of interests in family-controlled entities and welcome a clarification in that regard in the final regulations. If correctly understood, the assurances alleviate our prior concern that a transfer of an interest that results in a lapse of a liquidation right could cause the gifted and retained interests' liquidation values to be taxed twice via an application of the "disregarded restriction" rules and the rules of Prop. Reg. § 25.2704-1(c)(1) that would be applicable if the transfer does not qualify for the Proposed Narrowed Exception. We respectfully request that clarification of this issue be included in any revised regulatory guidance that is released.

E. Requested Clarity Regarding Individuals Required to "Control" Entity for Purposes of Prop. Reg. §§ 25.2704-2 and 25.2704-3

Each of Prop. Reg. §§ 25.2704-2 and 25.2704-3 provides that it applies only if "the transferor and/or members of the transferor's family" control an entity immediately prior to a transfer of an interest in it. Each Proposed Regulation directs that "member of the family" be defined by Treas. Reg. § 25.2702-2(a)(1), which defines that term to include the transferor's spouse, ancestors and descendants of either the transferor or the transferor's spouse, the transferor's siblings, and spouses of the foregoing. Code § 2704(c)(2) provides an identical definition for "member of the family."

Existing Treas. Reg. § 25.2704-2 references Treas. Reg. § 25.2701-2(b)(5) as providing the definition for the term "control." However, Prop. Reg. §§ 25.2704-2 and 25.2704-3 reference Treas. Reg. § 25.2701-2(b)(5) (also modified pursuant to the Proposed Regulations) as providing the definition of the term "controlled entity" but do not direct that it or any other regulation define the term "control." Curiously, "controlled entity" does not appear to be a term of consequence in either of those Proposed Regulations, although each uses the term "family-controlled entities" in a seemingly descriptive manner and not as a term with any apparent technical significance. The reference to Treas. Reg. § 25.2701-2(b)(5) in each of Prop. Reg. §§ 25.2704-2 and 25.2704-3 for a definition of "controlled entity" and not simply "control" has created confusion as to the individuals who are required to possess control of an entity in order for transfers of interests in it to be subject to Code § 2704(b).

The confusion stems from the two-part manner in which Prop. Reg. § 25.2701-2(b)(5) defines "controlled entity." It outlines the type and level of interests for determining "control" of each type of entity. However, in Treas. Reg. § 25.2701-2(b)(5)(i), it also lists the individuals whose ownership of those interests "count" for purposes of characterizing an entity as a "controlled entity," and those individuals are not identical to those defined as "members of the transferor's family." For determining what constitutes a controlled entity, "applicable family members" must be considered. Specifically, spouses of the transferor's descendants are "members of the transferor's family," but any interests they hold in an entity do not "count" in determining whether it is a "controlled entity" for purposes of Code § 2701. Conversely, neither (i) descendants of the transferor's siblings nor (ii) siblings or descendants of siblings of the transferor's spouse are to be considered "members of the transferor's family" but any interests they hold in an entity do "count" in determining whether it is a "controlled entity" because they are applicable family members.

We believe that the individuals who are required to hold control of an entity in order for transfers of interests in it to be subject to Code § 2704(b) are solely those referenced in the definition of "member of the family." We believe that any attempt by the Treasury and the IRS to expand that list of individuals to include those additional individuals referenced in the definition of "controlled entity" would be an inappropriate exercise of the authority provided to them pursuant to Code § 2704(b)(4) to issue the Proposed Regulations. If Treas. Reg. § 25.2702-2(a)(1) is confirmed as providing the appropriate listing of those individuals, then we propose that the first sentence of each of Prop. Reg. § 25.2704-2(c) and Prop. Reg. § 25.2704-3(c) be revised to read: "For the definition of control, see § 25.2701-2(b)(5)(ii), (iii), or (iv), as applicable."

F. Requested Clarity Regarding Apparent Broadening of Family Attribution Principles

Code § 2704(b)(3)(B) (the "Exception") provides that the term "applicable restriction" shall not include any restriction imposed, or required to be imposed, by federal or state law. Treas. Reg. § 25.2704-2(b) currently provides that an applicable restriction is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under state law generally in the absence of the restriction. Thus, Treasury and the IRS have interpreted the word "imposed" to refer to the default provisions of state law applicable in the absence of a contrary provision in an entity's governing instrument.

However, Treasury and the IRS have now proposed a narrower interpretation of the Exception in Prop. Reg. § 25.2704-2(b)(4)(ii) (for applicable restrictions) and § 25.2704-3(b)(5)(iii) (for "disregarded restrictions"). Together, those sections direct that a provision of state or federal law that may be overridden in the partnership agreement or otherwise superseded (whether by the partners or otherwise) is not a restriction that is "imposed or required to be imposed by federal or state law." As explained in the Preamble, Treasury and the IRS feel this narrower interpretation is now appropriate because the "current regulations have been rendered substantially ineffective in implementing the purpose and intent of the statute by changes in state laws" that may on their face substantiate the need for valuation discounts but in Treasury's and the IRS's estimation are likely to be circumvented by the other partners' willingness to accommodate a family member's request that those restrictions be removed.

Effectively, Treasury and the IRS now seem to interpret "impose" as a reference to a non-waivable state or federal restriction, which begs the question of what is to be considered a restriction "required to be imposed" by state or federal law. Some practitioners have speculated that this second prong of the Exception may refer to a state or federal law requiring the actual incorporation in the partnership agreement of a specific restriction on a limited partner's withdrawal right or the right of a limited partnership to liquidate.

We are unaware of any state law provision restricting a limited partner's withdrawal right or the right of a limited partnership to liquidate that cannot be overridden in the partnership agreement. We are also unaware of any state or federal law that requires such a non-waivable provision be incorporated in a partnership agreement. Thus, it seems unlikely that any restriction in a partnership agreement on a limited partner's withdrawal right or the right of a limited partnership to liquidate will qualify for the Exception, as interpreted in the Proposed Regulations. We are concerned that Treasury and the IRS have consequently narrowed the Exception to the extent it will have little or no effect and thus will have been rendered meaningless, which suggests that the Treasury and the IRS have exceeded their Congressional authority in adopting this interpretation. The Proposed Regulations appear to have broadened the application of family attribution principles beyond the few instances in which Congress intended that it be assumed that family members will unite to disregard actual lapses of voting or liquidation rights or restrictions on an entity's liquidation to substantiate an artificially higher value for a transferred (or deemed transferred) limited partnership interest than would otherwise apply.

Congress indicated in the legislative history to Chapter 14 its awareness of the courts' refusal to consider familial relationships among co-owners in valuing transferred interests in family entities and its intent that Chapter 14 not affect discounts available under then present law. 136 Cong. Rec. 15679, 15681 (October 18, 1990); H. Conf. Rept. 101-964, at 1137 (1990), 1991-2 C.B. 560, 606. We believe this effective invalidation of the Exception and corresponding expansion of family attribution principles conflicts with Congress's intent in enacting Chapter 14 and case law of continuing precedential value and may only be undertaken by Treasury and the IRS pursuant to an explicit Congressional directive.

In light of the foregoing, we respectfully suggest that Treasury and the IRS revise Prop. Reg. §§ 25.2704-2(b)(4)(ii) and 25.2704-3(b)(5)(iii) to retain the "no more restrictive standard" set forth in § 25.2704-2(b) of the current regulations. Alternatively, if the Treasury and the IRS will not return to the standard of the current regulations, we respectfully request that Treasury add additional examples to the Proposed Regulations that illustrate circumstances under which the Exception will have effect under the new standard contained in Prop. Reg. §§ 25.2704-2(b)(4)(ii) and 25.2704-3(b)(5)(iii).

III. CONCLUSION

We greatly appreciate the opportunity to work with your office on these significant tax issues and hope these comments provide relevant analysis for your review. Thank you for your consideration.

TAX SECTION
State Bar of Texas

August 7, 2017

Via e-mail: Notice.Comments@irscounsel.treas.gov
and FedEx Overnight Delivery

Internal Revenue Service
CC:PA:LPD:PR (Notice 2017-38)

Courier's Desk
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

RE: Comments in Response to Notice 2017-38 Regarding Final Regulations Under Section 7602 on the Participation of a Person Described in Section 6103(n) in a Summons Interview

Dear Ladies and Gentlemen:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Department of the Treasury ("Treasury") and the Internal Revenue Service ("IRS" or the "Service") in Notice 2017-38 for comments regarding the final regulations issued under Section 7602 on the participation of a person described in Section 6103(n) in a Summons Interview (the "Regulations").[1]

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

[1] See T.D. 9778, 81 Fed. Reg. 45409 (July 14, 2016). Unless otherwise indicated, all "Section" or "§" references in this cover letter and attached comment are to the Internal Revenue Code of 1986, as amended.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend Treasury and the Service for requesting comments regarding the Regulations and appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Stephanie M. Schroepfer

Stephanie M. Schroepfer, Chair
State Bar of Texas, Tax Section

SS/lab
Enclosure

COMMENTS REGARDING FINAL REGULATIONS UNDER SECTION 7602 ON THE PARTICIPATION OF A PERSON DESCRIBED IN SECTION 6103(N) IN A SUMMONS INTERVIEW

These comments on the Regulations ("Comments") are submitted on behalf of the Tax Section of the State Bar of Texas ("Tax Section"). Principal responsibility for drafting these Comments was exercised by Richard L. Hunn, who is Co-Chair of the Tax Controversy Committee of the Tax Section. The Committee on Government Submissions ("COGS") of the Tax Section has approved these Comments. Jeffry M. Blair, Co-Chair of COGS, reviewed these Comments. Robert C. Morris also reviewed the comments and made substantive suggestions on behalf of COGS.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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I. INTRODUCTION

Section 2(a) of Executive Order 13789 required Treasury to identify regulations that (i) impose an undue financial burden on U.S. taxpayers; (ii) add undue complexity to the Federal tax laws; or (iii) exceed the statutory authority of the IRS.[2] Treasury identified the Regulations as one of eight regulations that meet at least one of the first two criteria. These Comments are provided in response to the request of Treasury and the IRS for comments regarding whether the Regulations should be rescinded or modified, and in the latter case, how the Regulations should be modified in order to reduce burdens and complexity.

II. BACKGROUND

The Regulations were originally proposed and promulgated in temporary form on June 18, 2014, and Treasury and the IRS solicited comments on the proposed regulations.[3] On September 16, 2014, the Tax Section submitted comments ("Prior Tax Section Comments"). The Tax Section was the only group that submitted comments at the time that Treasury and the IRS requested comments. However, other comments were later submitted.

In the Prior Tax Section Comments, we expressed our concern with, and requested that the IRS remove, a provision in the proposed/temporary regulations that would have permitted a third-party, private contractor to question a summoned witness under oath or request the witness's representative to clarify an objection or assertion of privilege ("Private Contractor Questioning Provision"). Our recommendation was not adopted, and the Regulations (with one minor modification) were finalized on July 14, 2016.[4] We respectfully continue to recommend that the Private Contractor Questioning Provision be removed from the Regulations.

III. RECOMMENDATION

Before addressing the Private Contractor Questioning Provision, we wish to reiterate our belief that the Regulations are helpful in clarifying that a person who is authorized to receive returns and return information under Section 6103(n) and Treasury Regulations § 301.6103(n)-1(a) may also receive and examine books, papers, records or other data produced in compliance with a summons, that such person may be present during a summons interview, and that such person may, in the course of a summons interview, receive, review and use summoned books, papers, records, or other data. We also believe that it is appropriate for such person to advise and consult with IRS officers or employees during the course of a summons interview.

However, we continue to respectfully recommend that a private, third-party contractor not be permitted to question a summoned witness under oath or request the witness's representative to clarify an objection or assertion of privilege. The revised wording for Treasury Regulations § 301.7602-1(b)(3), incorporating our suggestion by removing the Private Contractor Questioning Provision, could read as follows:

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[2] Executive Order No. 13789, §2(a), 82 Fed. Reg. 19317 (2017).
[3] T.D. 9669, 79 Fed. Reg. 34625, 34668 (June 18, 2014).
[4] T.D. 9778, 81 Fed. Reg. 45409 (July 14, 2016).

(b)(3) *Participation of a person described in section 6103(n).* For purposes of this paragraph (b), a person authorized to receive returns or return information under section 6103(n) and § 301.6103(n)-1(a) of the regulations may receive and review books, papers, records, or other data produced in compliance with a summons and, in the presence and under the guidance of an IRS officer or employee, participate in the interview of a witness summoned by the IRS to provide testimony under oath. Participating in such an interview means receipt, review and use of summoned books, papers, records, or other data, being present during summons interviews, taking notes during summons interviews, and advising and consulting with an IRS officer or employee regarding the IRS officer or employee's questioning of the witness.

IV. DISCUSSION

We recognize and understand that the IRS may have anticipated obtaining certain benefits from including the Private Contractor Questioning Provision in the Regulations, but we respectfully continue to have prudential concerns about the operation of that provision in practice.

The examination of witnesses is inherently fluid and situation specific. Every interview is different. It is not realistic or practical for the private, third-party contractor to have all of the questions scripted and approved by the IRS employee or officer in advance of the interview. Consequently, the mere presence of an IRS officer or employee who ostensibly remains in charge of the interview is of little comfort if the taxpayer must rely on the IRS officer or employee to interrupt the contractor mid-question to prevent an improper line of inquiry. This is of even less comfort for taxpayers who cannot afford to or have not engaged a representative to be present for the interview.

Moreover, having multiple persons on the record—the IRS officer or employee, the private contractor, the witness, and the witness's representative—may lead to a cluttered, incomprehensible transcript of the interview. This is especially true if the IRS officer or employee must interrupt the questioning to maintain control of the examination. In the preamble to the Regulations, the IRS asserts that in its experience when a witness has been questioned by more than one IRS officer or employee, it has not resulted in a cluttered or incomprehensible transcript, and the IRS asserts that it should therefore not be a problem if a contractor were also allowed to question the witness.[5] That has not been our experience. In our experience, when multiple persons attending the examination of a witness are authorized to speak, it can result in a cluttered, incomprehensible transcript. The point is if there is even a chance of multiple persons hurting the quality of the transcript, why unnecessarily increase the risk of that happening by increasing the number of persons authorized to speak?

We believe that the analogous practice at trial and deposition may be instructive. In a trial (or deposition), if examining counsel wishes to confer with co-counsel or a consultant, he or she may ask the court (or court reporter) for leave for a brief consultation. When counsel is

[5] *See* Preamble to the Regulations at Explanation and Summary of Comments, 1. Potential for IRS Loss of Control over Interview, T.D. 9778, 81 Fed. Reg. 45409 (July 14, 2016).

ready, he or she will typically announce to the court (or court reporter) that he or she is ready to proceed, the court goes back on the record, and the examination continues.

We suggest that a similar process be followed in a summons interview. During the summons interview, the IRS officer or employee examining the witness would simply announce to the court reporter that he or she needs a moment to confer with the private contractor and then confer with that contractor. After the consultation, the IRS officer or employee would announce they were ready to go back on the record, and the examination of the witness would continue. We respectfully believe that proceeding in this manner would result in a more orderly proceeding and a cleaner, more comprehensible transcript of the interview.

Importantly, our suggestion also would avoid the unsettled question of whether a private contractor has the legal authority to examine a witness. The Regulations allowing a private contractor to question a witness during a summons interview may exceed the scope of the statute that authorizes summons interviews. Specifically, Section 7602(a) provides in pertinent part:

> . . . the Secretary is authorized—
>
> . . .
>
> (3) To take such testimony of the person concerned, under oath, as may be relevant or material to such inquiry.

Section 7701(a)(11) defines "Secretary" to mean "the Secretary of the Treasury or his delegate." Section 7701(a)(12)(A)(i) in turn defines "or his delegate" in pertinent part as follows:

> . . . when used with reference to the Secretary of the Treasury, means any officer, employee, or agency of the Treasury Department duly authorized by the Secretary of the Treasury directly, or indirectly by one or more redelegations of authority, to perform the function mentioned or described in the context . . .[6]

Section 7602(a), by its express terms, authorizes only an officer, employee or agency of the Treasury Department to take testimony of witnesses. The substance of the language in Section 7701(a)(12)(A)(i) can be traced all the way back to the Internal Revenue Code of 1954.[7]

Since the enactment of the Internal Revenue Code of 1954, we have not located any construction of the term "agency of the Treasury Department" to mean anything other than a bureau or branch of the Department. If the term were meant to refer to a third party agent, presumably it would have been framed as "agent of the Treasury Department." Historically, delegations by regulation, delegation orders and re-delegation orders have been used to delegate

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[6] *See Howard v. Adle*, 538 F. Supp. 504, 507 (E.D. Mich. 1982) (interpreting this definition to be exclusive).

[7] *See* Internal Revenue Code of 1954 § 7701(a)(12) ; H.R. Rep. No. 83-1337, at A437 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4017, 4586; S. Rep. No. 83-1622, at 619 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4621, 5270.

authority only to officers and employees of the Treasury Department, and that has been the case with respect to delegations of authority to take testimony pursuant to a summons.[8]

We are unaware of such regulations or orders previously being used to delegate authority to third party contractors. This suggests that statutory authorization may be required for such delegation. Indeed, the law presumes that Congress did not intend to allow an agency to redelegate its authority to an outside party absent express statutory authorization.[9] For example, when the IRS was authorized to hire private contractors to perform tax collection functions in 2004, Congress enacted a statute, Section 6306 specifically authorizing it.[10]

We raised this example in the Prior Tax Section Comments, and other commenters also raised it. In response, the IRS asserted in the preamble to the Regulations that the IRS has for many years contracted with private persons to assist with tax collection, for example locksmiths, tow truck drivers, storage facilities, property appraisers, and auctioneers.[11] The IRS further asserted that in 1996 and 1997 Congress, without modifying the Internal Revenue Code, appropriated $13 million for the IRS to test the use of private debt collection companies.[12] Finally, the IRS pointed to the language of Section 6306(a), which states that "[n]othing in any provision of law shall be construed to prevent the Secretary from entering into a qualified tax collection contract," and asserts that Section 6306 was merely a "congressional clarification of the IRS's existing authority to engage outside contractors to assist with collection." [13]

We respectfully suggest that if the IRS always had the authority to hire private tax collectors, then Congress would not have acted by passing legislation. In 1996 and 1997, Congress passed legislation (even though it was not codified) appropriating funds for a test program of hiring private debt collection companies.[14] In 2004, Congress acted by enacting Section 6306 establishing the program on a more permanent basis.

To the extent the Regulations rely on some more general, pre-existing grant of authority to hire outside contractors, we believe it does not suffice here where a specific delegation of authority is in question. We respectfully believe that the present situation involves a specific

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[8] *See* Treas. Reg. § 301.7701-9; Treasury Order No. 150-10; Delegation Order 1-23 (formerly DO-193, Rev. 6) at I.R.M. § 1.2.40.21(2) and (3); Delegation Order 25-1 (formerly DO-4, Rev. 23) at I.R.M. § 1.2.52.2, which include delegations and redelegations of authority to various officers and employees of the Treasury Department to take testimony under oath of the person summoned.

[9] *United States Telecom Ass'n v. F.C.C.*, 359 F.3d 554, 565 (D.C. Cir. 2004) ("[t]he case law strongly suggests that subdelegations to outside parties are assumed to be improper absent an affirmative showing of congressional authorization").

[10] *See, e.g.,* § 6306, which was enacted by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 881(a)(1), 118 Stat. 1625 (2004). In 2009, Congress deactivated that program by defunding it, and in 2015, Congress reactivated that program by legislation. *See* Omnibus Appropriations Act of 2009, Pub. L. No. 111-8, Division D, § 106, 123 Stat. 636 (2009); Fixing America's Surface Transportation Act of 2015, Pub. L. No. 114-94, § 32102, 129 Stat. 1733 (2015).

[11] *See* Preamble to the Regulations at Explanation and Summary of Comments, 2. Statutory Authority for an Outside Contractor to Question a Summoned Witness, T.D. 9778, 81 Fed. Reg. 45409 (July 14, 2016).

[12] *Id.*

[13] *Id.*

[14] *See* Treasury, Postal Service, and General Government Appropriations Act, 1996, Pub. L. No. 104-52, 109 Stat. 468, 473-474, 476 (1996).

statutory delegation of authority, pursuant to Section 7206(a), to officers and employees of the Treasury Department to examine summoned witnesses under oath. A general grant of agency authority cannot override the scope of a specific delegation by Congress in a statute such as Section 7206(a).[15]

The preamble to Regulations referred to Treasury Regulations § 301.7602-2(c)(1)(i)(B) and (c)(1)(ii) Example 2.[16] That regulation, for purposes of notice of third party contacts by the IRS under Section 7602(c), treats private contractors as if they were IRS employees. However, that regulation also specifically provides, "No inference about the employment or contractual relationship of such other persons [i.e., private contractors] with the IRS may be drawn from this regulation for any purpose other than the requirements of section 7602(c)."[17] Thus, that regulation apparently would not provide the necessary authorization for the Regulations.

Because the Regulations arguably exceed the statutory authority under Section 7602(a) by allowing a private contractor to examine a witness under oath, the Prior Tax Section Comments recommended that the Contractor Questioning Provision be removed. Specifically, we cautioned in the Prior Tax Section Comments that the Contractor Questioning Provision would result in litigation, and the expenditure of substantial time and resources by the IRS, taxpayers, third party witnesses and the courts. We cautioned that these costs (even if the IRS prevails) would outweigh the potential benefits from allowing a private contractor to examine a witness under oath, rather than simply consult with the IRS agent questioning the witness.

Subsequent events proved our concerns to be well founded. In December of 2014, the United States initiated summons enforcement actions on behalf of the IRS against Microsoft Corporation. The IRS had hired a private law firm to question summoned witnesses under oath pursuant to the temporary regulations (which were later finalized as the Regulations), and Microsoft resisted on the grounds that the temporary regulations were invalid because they exceeded the scope of Section 7602(a).[18] After nearly a year of hard-fought litigation, the district court issued its opinion rejecting Microsoft's argument, and the IRS "won."

In truth, nobody won. The government, the taxpayer, and the court expended substantial time and resources litigating a procedural issue which would not have arisen if Treasury and the IRS had not included language in the temporary regulations (and now in the Regulations) permitting third party contractors to examine summoned witnesses under oath. A district court opinion in the Western District of Washington does not preclude taxpayers in other districts from litigating this issue, and we believe that, unless the Regulations are modified to remove that language, litigation in other districts may well follow.

This issue has also gotten the attention of members of Congress. In a May 13, 2015 letter to the Commissioner of the IRS, U.S. Senate Finance Committee Chairman Orrin Hatch, noted

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[15] *United States v. Giordano*, 416 U.S. 505, 513-514 (1974); *Halverson v. Slater*, 129 F.3d 180, 185-186 (D.C. Cir. 1997).

[16] *See* Preamble to the Regulations at Explanation and Summary of Comments, 2. Statutory Authority for an Outside Contractor to Question a Summoned Witness, T.D. 9778, 81 Fed. Reg. 45409 (July 14, 2016).

[17] Treas. Reg. § 301.7602-2(c)(1)(i)(B).

[18] *See United States v. Microsoft Corp.*, 154 F. Supp. 3d 1134 (W.D. Wash. 2015).

that the provision in the temporary regulations (now the Regulations) permitting third party contractors to examine summoned witnesses under oath appeared to violate federal law because it exceeded the scope of Section 7602(a). Senator Hatch requested an explanation and asked that the IRS immediately halt the use of private contractors to take sworn testimony.[19] As Treasury and the IRS have acknowledged in Notice 2017-38, the Senate Finance Committee in 2016 approved legislation that would prohibit the IRS from delegating to third party contractors the authority under Section 7602.[20] In 2017, similar legislation was introduced in the U.S. House of Representatives.[21]

Ultimately, our concern is prudential. We believe that any benefits to the IRS from the Contractor Questioning Provision are far outweighed by the trouble that they have already caused and may continue to cause in the future. We respectfully reiterate our recommendation made three years ago in the Prior Tax Section Comments that Treasury and the IRS remove the Contractor Questioning Provision.

We appreciate the opportunity to provide these comments to the Regulations.

[19] *See* https://www.finance.senate.gov/chairmans-news/hatch-questions-irss-outsourcing-of-taxpayer-examination.
[20] Taxpayer Protection Act of 2016, S. 3156, 114th Cong. § 6 (2016).
[21] Preserving Taxpayers' Rights Act, H.R. 3220, 115th Cong. § 135 (2017).

TAX SECTION
State Bar of Texas

August 11, 2017

Via Federal eRulemaking Portal
at www.regulations.gov

Internal Revenue Service
CC:PA:LPD:PR (REG-136118-15)

Courier's Desk
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

RE: Comments on Proposed Regulations Regarding Implementing Centralized Partnership Audit Regime

Dear Ladies and Gentlemen:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Department of the Treasury ("Treasury") and Internal Revenue Service (the "Service") in the Notice of Proposed Rulemaking (REG-136118-15) issued on June 14, 2017 (the "Proposed Regulations"). The Proposed Regulations provide rules concerning the implementation of the new centralized partnership audit regime (the "Regime") enacted by section 1101 of the Bipartisan Budget Act of 2015, as corrected and clarified by the Protecting Americans from Tax Hikes Act of 2015.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF

LAW. THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend the Treasury and Service for the time and thought that has been put into preparing the Proposed Regulations, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Stephanie Schroepfer

Stephanie M. Schroepfer, Chair
State Bar of Texas, Tax Section

SS/lab
Enclosures

COMMENTS ON PROPOSED REGULATIONS IMPLEMENTING CENTRALIZED PARTNERSHIP AUDIT REGIME

These comments on the Proposed Regulations (the "Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafters of these Comments were Corey M. Junk, Member of the Tax Section, Carol G. Warley, Vice-Chair of the Estate and Gift Tax Committee, Laurel Stephenson, Co-Chair of the Estate and Gift Tax Committee, Celeste C. Lawton, Co-Chair of the Estate and Gift Tax Committee, and Matthew S. Beard, Co-Chair of the Estate and Gift Tax Committee. The Committee on Government Submissions (COGS) of the Tax Section of the State Bar of Texas has approved these Comments. Jeffry M. Blair, Co-Chair of COGS, reviewed these Comments. Catherine C. Scheid, Chair Elect of the Tax Section, reviewed the Comments and made substantive suggestions on behalf of COGS.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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I. INTRODUCTION

These Comments are provided in response to Treasury and the Service's request for comments regarding the Proposed Regulations, which provide rules concerning the implementation of the Regime, which was enacted into law on November 2, 2015 by section 1101 of the Bipartisan Budget Act of 2015, Pub. L. No. 114-74 (the "BBA"), as corrected and clarified by the Protecting Americans from Tax Hikes Act of 2015, Pub. L. 114-113, div. Q (the "PATH Act"). The BBA repeals the current rules governing partnership audits, including those enacted under the Tax Equity and Fiscal Responsibility Act ("TEFRA"), for tax years beginning after December 31, 2017. The BBA replaces those rules with the Regime, which generally assesses and collects tax at the partnership level rather than the partner level. We appreciate the opportunity to comment on the Proposed Regulations.

We recognize the time and thoughtful work invested by Treasury and the Service in preparing the Proposed Regulations and the accompanying explanatory preamble to the Proposed Regulations. These efforts are extremely useful to taxpayers and practitioners. It is our intent to present items for consideration that may help and support Treasury and the Service in this endeavor to provide clear regulatory guidance.

II. COMMENTS REGARDING EXPANSION OF DEFINITION OF "ELIGIBLE PARTNERS" TO INCLUDE TRUSTS

We understand that Treasury and the Service have previously considered and declined to exercise the regulatory authority provided in Code[1] § 6221(b)(2)(C) to include trusts as the types of entities that are eligible partners for purposes of the election out rules because Treasury and the Service believe that including trusts as eligible partners would add to the Service's administrative burdens in examining partnerships and trust-partners under the deficiency rules. However, we respectfully ask Treasury and the Service to reconsider allowing trusts to be eligible partners because as outlined below (1) not allowing trusts as eligible partners while allowing estates and S corporations as eligible partners could lead to unfair treatment of similarly situated taxpayers, and (2) not allowing trusts as eligible partners could potentially increase the Service's administrative burden and lead to decreased tax revenue.

A. Potential Disparate Treatment of Similarly Situated Taxpayers

We respectfully request that the Service include simple, complex, and grantor trusts as eligible partners for purposes of determining a partnership's eligibility to opt out of the Regime. Similarly situated taxpayers should be treated similarly. Extending eligible partner status to grantor trusts, in particular, would allow for consistency with the inclusion of individuals given that grantor trusts are treated as indistinguishable from the grantors who settled and funded them for income tax purposes. Because all taxable income from a grantor trust is includible in the

[1] All references herein to the "Code §" or "Section" are to the Internal Revenue Code of 1986, as amended, and all references to "Treas. Reg. §" and "Prop. Reg. §" are to the current and proposed regulations.

grantor's taxable income, any adjustments to partnership income apportioned to a grantor trust would ultimately be reflected on the individual return of the trust's grantor. This is entirely consistent with the treatment of individuals as partners and results in similar treatment of similarly situated taxpayers. This could be accomplished by requiring the inclusion of a disclosure by the partnership of the name and taxpayer identification number of the trustee and the name and taxpayer identification number of each grantor deemed an owner of the trust.

Simple trusts, by their terms, are required to distribute their accounting income at least annually to the current income beneficiaries. Assuming all of the partnership income is trust accounting income and that there are no capital gains, the treatment of simple trusts is similar to the treatment of S Corporations. S Corporation income is included in the taxable income of the underlying shareholder(s). A simple trust that distributes all of the trust's taxable income results in inclusion in the beneficiary's taxable income. Thus, the effect of any adjustment at the partnership level would pass through the trust to the beneficiary in much the same way any adjustment passes through the S Corporation partner to the underlying shareholder(s). If the simple trust has not distributed all of its taxable income (e.g., it has capital gains), then it would be treated in a similar fashion to a complex trust. See our analysis of the treatment of complex trusts below.

Just as the Code and Proposed Regulations provide for special rules for S Corporations to follow in order to qualify as eligible partners for purposes of the partnership's eligibility to opt out of the Regime, the Service could similarly include rules for simple trusts to follow in order to qualify as eligible partners. This could be accomplished by requiring the inclusion of a disclosure by the partnership of the name and taxpayer identification number of the trustee, each beneficiary of the trust who receives a Schedule K-1 during the election year, and any other person that the Secretary determines to be necessary and proper. For purposes of the 100-or-fewer-statements limitation for electing out, each of such persons could then be considered as if each were a statement recipient. In our experience, the average number of beneficiaries of a trust is generally less than the average number of S corporation shareholders. As trusts have administration issues similar to those of S Corporations, we believe the administrative burden placed on the Service by including simple trusts as eligible partners would not be more onerous than the burden placed on the Service by including S Corporations (aside from the burden associated with expanding the number of partnerships consequently eligible to opt out of the Regime). Thus, inclusion of simple trusts would allow for similar treatment of similarly situated taxpayers.

Including complex trusts as eligible partners would be substantially similar to the treatment afforded to the estates of deceased partners under the Proposed Regulations. The fiduciaries of both complex trusts and estates are typically granted discretion over the timing and often the amount of distributions to beneficiaries, and both entities are subject to the taxation of retained taxable income over a minimal exemption amount. Inclusion of complex trusts as eligible partners would maintain consistency in the treatment of similarly situated taxpayers as it pertains to partnership eligibility for the purposes of electing out of the Regime.

The Proposed Regulations do not require estates of deceased partners to disclose any information relating to the executor(s) or the beneficiaries of the estate. However, this does not preclude the Secretary from requiring that complex trusts be made subject to similar rules as those proposed above for use with grantor and simple trusts, if doing so would ease the Service's administrative burden. A partnership with a complex trust partner could be required to include a disclosure containing the same information required of grantor and simple trusts with regard to (as applicable) trustees, grantors who are deemed owners of the trust, beneficiaries receiving a Schedule K-1 for the election year, and any other persons the Secretary determines are necessarily and properly disclosed (the "Indirect Partners").

In summary, we respectfully request that the Service not restrict the ability of partnerships with partners who are trusts to elect out of the Regime in situations where the rules are otherwise satisfied and the name and taxpayer identification number for each Indirect Partner is known to the partnership and disclosed to the Service. As noted above, the exclusion of trusts from the list of eligible partners could potentially result in disparate treatment of similarly situated taxpayers. Also, inclusion of trusts would arguably be no more burdensome than the inclusion of the entities enumerated in the statute (aside from the burden associated with expanding the number of partnerships consequently eligible to opt out of the Regime).

B. Potential Burden to Service and Reduction in Tax Revenue

In the explanatory preamble to the Proposed Regulations, the Service noted that it would be particularly helpful if any comments expanding the election out rules, which would include comments made to expand the definition of eligible partner, were to address the additional burdens any such expansion would impose on the Service.

For the reasons we briefly outlined above, we believe that the term eligible partner should include all three categories of trusts (*i.e.*, grantor trusts, simple trusts, and complex trusts). Although including these trusts as eligible partners would add to the Service's administrative burden by increasing the number of partnerships eligible to opt out of the Regime, not including trusts as eligible partners could potentially increase the administrative burden to the Service and lead to decreased tax revenue, as discussed below.

If trusts are not included as eligible partners, we believe that the perceived unfairness and cumbersomeness of the Regime will inevitably translate into reduced fair market values for limited partnership interests. Investors in partnerships that permit trusts as partners and are consequently subject to the Regime are likely to pay less for a partnership interest than they would have paid prior to the enactment of the BBA (all other factors being equal) due to the associated increased risks and burdens of holding an interest in that partnership (e.g., the risk of an audit adjustment resulting in taxation at the highest taxable rate, ignoring the unique tax situation of each individual partner). Correspondingly, investors in partnerships that do not permit trusts as partners in order to remain eligible to "opt out" of the Regime also are likely to pay less for a partnership interest than they would have paid prior to the enactment of the BBA due to the elimination of potential transferees of that interest, whether via their own estate planning or upon sale. If, as is anticipated, the fair market values of limited partnership interests are reduced because trusts are not eligible partners, there is a high probability that the Service will expend additional time and resources in challenging those valuations, which could outweigh the administrative burden associated with allowing trusts to be eligible partners. In addition, reduction in the fair market values of limited partnership interests would result in a reduction in tax revenue, which would certainly be an unintended consequence of disallowing trusts as eligible partners.

III. CONCLUSION

We greatly appreciate the opportunity to work with your office on these significant tax issues and hope these comments provide relevant analysis for your review. Thank you for your consideration.

TAX SECTION
State Bar of Texas

October 27, 2017

Via U.S. Priority Express Mail and E-mail to Teresa.Bostick@cpa.texas.gov

Teresa G. Bostick
Director, Tax Policy Division
P.O. Box 13528
Austin, Texas 78711-3528

RE: Comments on Proposed Amendments to 34 Tex. Admin. Code § 3.588, concerning margin: cost of goods sold

Dear Ms. Bostick:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed comments pertaining to the proposed amendments to 34 Tex. Admin. Code § 3.588. The proposal appeared in the September 29, 2017, edition of the Texas Register.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE

GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend the Texas Comptroller of Public Accounts for the time and thought that has been put into preparing the proposed amendments to 34 Tex. Admin. Code § 3.588, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Stephanie Schroepfer / IA

Stephanie M. Schroepfer, Chair
State Bar of Texas, Tax Section

Enclosure

COMMENTS ON PROPOSED AMENDMENTS TO 34 TEX. ADMIN. CODE § 3.588

These comments on the proposed amendments to 34 Tex. Admin. Code § 3.588 ("Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafters of these Comments were Sam Megally, Chair of the State and Local Tax ("SALT") Committee of the Tax Section of the State Bar of Texas, Kirk Lyda and William LeDoux, Vice-Chairs of the SALT Committee, and Bucky Brannen, a member of the SALT Committee. The Committee on Government Submissions of the Tax Section of the State Bar of Texas has approved these Comments. Ira Lipstet, Vice-Chair of the Committee on Government Submissions, reviewed these Comments and made substantive suggestions on behalf of such Committee.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: October 27, 2017

I. INTRODUCTION

These Comments are in response to the publication of proposed amendments to 34 Tex. Admin. Code § 3.588, concerning margin: cost of goods sold (the "Proposed Amendments" or the "Proposal").

We recognize and appreciate the time and thoughtful work invested by the Comptroller's office in preparing the Proposed Amendments. We also appreciate the efforts of the Comptroller to survey existing authority and update existing rules. These efforts are extremely useful to taxpayers and practitioners. It is our intent to present items for consideration that may help and support Comptroller personnel in this endeavor.

II. COMMENTS REGARDING PROPOSED AMENDMENTS

34 Tex. Admin. Code § 3.588 ("Rule 3.588") relates to the cost of goods sold ("COGS") calculation. The Proposed Amendments would make several substantive changes to Rule 3.588 in order to implement recent legislative amendments, and appear as well to respond to recent court decisions interpreting the COGS calculation.

A. Movie Theaters

The Proposed Rule would add a new section to reflect the enactment of Tex. Tax Code § 171.1012(t) (West 2017),[1] which explicitly confirms that taxable entities that are movie theaters may subtract COGS in relation to the acquisition, production, exhibition, or use of a film or motion picture. H.B. 500, which added Section 171.1012(t), provides that the subsection was "a clarification of existing law and does not imply that existing law may be construed as inconsistent with the law as amended by this section."[2]

Accordingly, in addition to various costs associated with film or motion picture acquisition, movie theaters may also subtract COGS with respect to other items, such as concessions, meeting Section 171.1012's general COGS requirements as they have always been permitted to do. We respectfully suggest that the Comptroller make clear in Rule 3.588 that movies theaters' COGS are not limited only to the items listed in Section 171.1012(t), by adding the following italicized language:

> "Effective for reports originally due on or after September 1, 2013, if a taxable entity that is a movie theater elects to subtract cost of goods sold, the cost of goods sold for the taxable entity shall be, *in addition to costs otherwise allowed by this section,* the costs described by this section in relation to the acquisition, production, exhibition, or use of a film or motion picture, including expenses for the right to use the film or motion picture."[3]

[1] Unless otherwise provided, all references to "Section" relate to Tex. Tax Code Ann. (West 2017) and all references to "Rule" refer to 34 Tex. Admin. Code.

[2] H.B. 500, 83rd Leg., R.S. (2013).

[3] *See* 34 Tex. Admin. Code §3.588(c)(8) (proposed September 29, 2017, 42 Tex. Reg. 5235).

B. Presumption of Ownership

Section 171.1012(i) provides that "[a] taxable entity may make a subtraction under this section in relation to the costs of goods sold only if that entity owns the goods. The determination of whether a taxable entity is an owner is based on all of the facts and circumstances, including the various benefits and burdens of ownership vested with the taxable entity."[4] The legislative history pertaining to Section 171.1012(i) indicates that this section "[s]ets forth *the manner* in which taxable entities are determined to be the owner of real property, labor or materials, or goods being manufactured or produced."[5] Since Section 171.1012(i)'s enactment, Rule 3.588 has tracked this statutory language verbatim.[6]

The Proposed Rule, however, would add a rebuttable presumption that an entity that holds legal title to a good would be presumed the owner of that good for purposes of the COGS calculation.[7] Nowhere in Section 171.1012 is there such a presumption, and the Proposed Rule cites no authority for adding such a presumption. The presumption is not only contrary to the language in Section 171.1012(i) but also to the legislature's intent in enacting 171.1012(i). Accordingly, we respectfully suggest that the presumption be removed from the Proposed Rule, and that Rule 3.588 continue to recite verbatim the provision from Section 171.1012(i) quoted above.

C. Definition of Project

Section 171.1012(i) also provides that "[a] taxable entity furnishing labor or materials *to a project for* the construction, improvement, remodeling, repair, or industrial maintenance (as the term "maintenance" is defined in 34 T.A.C. Section 3.357) of real property is considered to be an owner of that labor or materials and may include the costs, as allowed by this section, in the computation of cost of goods sold."[8] This provision permits a taxable entity meeting its requirements to subtract COGS even though the entity may not itself own or sell goods within the meaning of the more general provisions of Section 171.1012.[9] The court in *Newpark Resources* concluded the provision is unambiguous,[10] and since enactment of Section 171.1012(i), Rule 3.588 has tracked this statutory language almost verbatim.[11]

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[4] Tex. Tax Code Ann. § 171.1012(i) (West 2017). This provision from Section 171.1012(i) has remained unchanged since its enactment in 2006 with the current form of the franchise tax. *See* Tex. H.B. 3, 79th Leg., 3rd C.S. (2006).

[5] *See* Bill Analysis (Senate), Tex. H.B. 3 § 5, 79th Leg., 3rd C.S. (2006) (emphasis added).

[6] 32 Tex. Reg. 10034 (2007).

[7] 34 Tex. Admin. Code §3.588(c)(9) (proposed September 29, 2017, 42 Tex. Reg. 5235).

[8] Tex. Tax Code § 171.1012(i) (West 2017) (emphasis added). Like the previous provision from Section 171.1012(i), this provision also has remained unchanged since its enactment in 2006 with the current form of the franchise tax. *See* Tex. H.B. 3, 79th Leg., 3rd C.S. (2006).

[9] *See Combs v. Newpark Res., Inc.*, 422 S.W.3d 46, 55 (Tex. App.—Austin 2013, no pet.).

[10] *Id.* at 56 n.9.

[11] 32 Tex. Reg. 10034 (2007).

Several appellate court cases have interpreted this provision.[12] Consistent with the unambiguous language of Section 171.1012(i), these decisions have broadly interpreted the provision to apply to activities that are "an essential and direct component" of *a project for* the construction, etc., of real property, and the courts have appropriately analyzed whether labor or materials are being furnished to *such project*. For instance, the courts have determined that the removal and disposal of drilling mud from oil and gas well drilling sites, and acquiring and processing seismic data that aid certain companies in determining where to explore and drill for oil and gas qualified for COGS under Section 171.1012(i), when such items were an essential and direct component of the drilling process.[13] The court in *Gulf Copper* suggested further that activities such as surveying offshore oil rigs to ensure compliance with specific project requirements may also qualify for COGS.[14]

The Proposed Rule, however, would provide that "[a] taxable entity furnishing labor or materials to a project is considered to be the owner of the labor or materials" and would define "project" as "[t]he construction, improvement, remodeling, repair, or industrial maintenance (as the term "maintenance" is defined in § 3.357 of this title (relating to Nonresidential Real Property Repair, Remodeling, and Restoration: Real Property Maintenance)) of real property."[15] Under this formulation, the Proposed Rule would essentially provide that "[a] taxable entity furnishing labor or materials to [the construction, etc., of real property] is considered the owner of the labor or materials."

However, consistent with the courts' analyses, Section 171.1012(i)'s inclusion of "*to a project for*" is broader and more encompassing than the mere construction, etc. of real property.[16] The Proposed Rule effectively defines out of the rule the "project" concept appearing in the statute, and is therefore not only inconsistent with the unambiguous language of Section 171.1012(i), but also contrary to the courts' determinations and analyses interpreting this statutory language. The courts have not interpreted Section 171.1012(i) as narrowly as the Proposed Rule's formulation suggests.

Accordingly, we respectfully suggest that the definition of "project" be removed from the Proposed Rule, and that Rule 3.588 continue to track the provision from Section 171.1012(i) quoted above.

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[12] *See generally Newpark Res.*, 422 S.W.3d 46; *Hegar v. CGG Veritas Servs. (U.S.), Inc.*, No. 03-14-00713-CV, 2016 WL 1039054 (Tex. App.—Austin Mar. 9, 2016, no pet.); *Hegar v. Gulf Copper & Mfg. Corp.*, No. 03-16-00250-CV, 2017 WL 3471064 (Tex. App.—Austin Aug. 11, 2017, no pet. h.).

[13] *See Newpark Res.*, 422 S.W.3d at 48; *CGG Veritas*, 2016 WL 1039054, at *2-4.

[14] *See Gulf Copper*, 2017 WL 3471064, at *14.

[15] 34 Tex. Admin. Code §3.588(c)(9)(B), (c)(9)(B)(iii) (proposed September 29, 2017, 42 Tex. Reg. 5235).

[16] *See Newpark Res.*, 422 S.W.3d at 55, 57 (noting that this provision is an exception to an initially restrictive subsection, and acknowledging that activities qualifying for COGS may be removed—but not "too far removed"—from the construction, etc. of real property); *see also CGG Veritas*, 2016 WL 1039054, at *5 (noting that the relationship of a taxable entity's activities "to a particular project" may be too attenuated to qualify for COGS, but finding CGG's activities qualified).

D. Definitions of Labor and Material

As explained above in (C), the court in *Newpark Resources* concluded that the "labor or materials provided to a project for the construction, etc. of real property" provision in Section 171.1012(i) is unambiguous; moreover, the courts in at least three appellate decisions have addressed whether a taxable entity furnishing labor to a project for the construction, etc. of real property is qualified to subtract COGS by analyzing whether the activities with respect to such labor are an "essential and direct component" of the project.[17]

The Proposed Rule, however, would define "labor" and "material" not by reference to the courts' holdings but with a new and additional "direct prosecution" test, which—according to the preamble to the Proposed Rule—comes from the Texas Property Code provisions related to mechanic's, contractor's, and materialman's liens, and was added to "reduce … uncertainty."[18] However, neither Section 171.1012 nor the courts provide support for using such a test.

Moreover, contrary to the preamble, the addition of such a test would likely add confusion—not certainty—to this area of the law. While taxpayers should clearly be able to rely on the court-approved "essential and direct" test, it remains unclear how that test would relate to a new "direct prosecution" test. At the very least, the Proposed Rule's definition of "labor" appears to be inconsistent with the courts' determinations.[19] Imposing an additional "direct prosecution" test is certain to complicate future analyses, and does not appear to solve the Comptroller's concern of uncertainty.

The Proposed Rule would also incorporate the definition of "material" from the Texas Property Code, including the "direct prosecution" test with respect to this term. Again, neither Section 171.1012(i) nor the courts provide support for this definition. Had the legislature intended this Texas Property Code definition to apply in the franchise tax context, it could have easily enacted it in the Texas Tax Code; the legislature, however, did not, and elected instead to require only that a taxable entity furnish labor and materials to a project for the construction, etc. of real property in order to qualify to subtract COGS.

We respectfully submit that Rule 3.588 should not include the proposed definitions of "labor" and "material" in the Proposed Rule. We also respectfully submit that the Proposed Rule's changes to Rule 3.588's "owner of goods" provisions in general are not supported by statute or case law and should not be adopted.

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[17] *See Newpark Res.*, 422 S.W.3d at 56; *CGG Veritas Servs. (U.S.), Inc.*2016 WL 1039054, at *3; *Gulf Copper*, 2017 WL 3471064, at *9.

[18] 34 Tex. Admin. Code §3.588(c)(9)(B), (c)(9)(B)(iii) (proposed September 29, 2017, 42 Tex. Reg. 5235).

[19] In addition to determining that the appropriate test is the "essential and direct component" test, the court in *Newpark* determined that the term "labor" "within the context of Section 171.1012(i) can be given a clear and definite meaning based solely on the plain language of the statute. *Newpark Res.*, 422 S.W.3d at 56 n.9. The court also determined that "labor" "is a broad term that encompasses a wide range of activities, including 'expenditure of physical or mental effort especially when fatiguing, difficult, or compulsory." *Id.* at 56.

E. Rental or Leasing Companies

The Proposed Rule also includes changes to the existing "rentals and leases" provisions in Rule 3.588(c)(9) that appear to restrict COGS beyond the statute. Section 171.1012(k-1) provides:

> (k-1) Notwithstanding any other provision of this section, the following taxable entities may subtract as a cost of goods sold the costs otherwise allowed by this section in relation to tangible personal property that the entity rents or leases in the ordinary course of business of the entity:
>
> (1) a motor vehicle rental or leasing company that remits a tax on gross receipts imposed under Section 152.026;
>
> (2) a heavy construction equipment rental or leasing company; and
>
> (3) a railcar rolling stock rental or leasing company.[20]

Pursuant to the statute, qualifying companies may thus subtract various costs associated with renting or leasing tangible personal property in the ordinary course of their businesses, including (1) direct costs of renting or leasing tangible personal property as described in Section 171.1012(c), and (2) the additional costs of renting or leasing tangible personal property as described in Section 171.1012(d).[21] The term "tangible personal property" is broadly defined to include "personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner."[22]

The Proposed Rule, however, would redefine the allowable subtraction for these rental or leasing companies from "costs . . . in relation to tangible personal property" to "costs . . . in relation to [motor vehicles, heavy construction equipment, railcar rolling stock]," potentially leading to a different and much narrower COGS calculation than allowed by the Tax Code and the existing Comptroller Rule.[23]

The preamble to the Proposed Rule cites the pending case *Hegar v. Sunstate Equipment Co., LLC*, but it is not clear that the case supports the proposed change.[24] Sunstate rented heavy construction equipment to its customers, thus qualifying for COGS, and sought to subtract costs of delivering such equipment to customer locations.[25] The court denied these costs based in part

[20] Tex. Tax Code § 171.1012(k-1) (West 2017). This provision has also remained unchanged since its enactment in 2006 with the current form of the franchise tax, and Rule 3.588 has tracked almost verbatim this statutory language since the enactment of Section 171.1012(k-1). *See* Tex. H.B. 3, 79th Leg., 3rd C.S. (2006); 32 Tex. Reg. 10034 (2007).

[21] *See generally* Tex. Tax Code § 171.1012.

[22] Tex. Tax Code § 171.1012(a)(3).

[23] *See* 34 Tex. Admin. Code §3.588(c)(11) (proposed September 29, 2017, 42 Tex. Reg. 5235).

[24] *See id.* § 3.588 (proposed September 29, 2017, 42 Tex. Reg. 5235); *see also Hegar v. Sunstate Equipment Co., LLC*, No. 03-15-00738-CV, 2017 WL 279602 (Tex. App.—Austin Jan. 20, 2017, pet. filed).

[25] *Sunstate Equipment*, 2017 WL 279602, at *3-4.

on the language in Section 171.1012(e)(3) and (6).[26] Whether Sunstate was allowed to subtract costs of renting or leasing tangible personal property other than heavy construction equipment was not at issue. The language cited in the preamble is thus dicta and does not support the proposed changes.

Sunstate filed a petition for review with the Texas Supreme Court; that petition remains pending.[27] The dicta cited in the preamble is thus not final.

We respectfully suggest that the Proposed Rule not include these changes and that Rule 3.588 instead continue to track Section 171.1012(k-1) quoted above. Moreover, we respectfully request that the Comptroller avoid citing pending litigation to support incorporating the Comptroller's litigation position into a formal Comptroller Rule unless and until such litigation position is upheld in a final and unappealable court holding.

III. REQUEST FOR ROUNDTABLE DISCUSSION

As drafted, the Proposal would make several substantive changes that could have significant effects on a broad range of taxpayers across multiple industries.

Before proceeding to adopt the Proposal, we respectfully request that the Comptroller's office convene a roundtable discussion of interested taxpayers and practitioners to address issues relating to COGS and the Comptroller's efforts to update Rule 3.588. We would welcome the opportunity to participate in such a meeting.

IV. CONCLUSION

We greatly appreciate the opportunity to work with your office on these significant tax issues and hope these Comments provide relevant analysis for your review. Thank you for your consideration.

[26] *Id.* at *5-6; *see also* Tex. Tax Code § 171.1012(e) ("The cost of goods sold does not include the following costs in relation to the taxable entity's goods: . . . (3) distribution costs, including outbound transportation costs . . . (6) rehandling costs.").

[27] *See Sunstate Equipment Co., LLC v. Hegar*, No. 17-0444 (petition for review filed July 24, 2017).

TAX SECTION OF
THE STATE BAR OF TEXAS

2017 – 2018 CALENDAR

July 2017	
Tuesday 07/04/17	**July 4th Holiday**
Monday 07/10/17	**Officer's Retreat** Norton Rose Fulbright US LLP 1301 McKinney, Suite 5100 Houston, Texas 77010
Thur - Sat 07/13/17 – 07/15/17	**Texas Bar College** Summer School Moody Gardens Hotel Galveston, TX
Saturday 07/15/17	**Tax Section Budget Deadline** (Budget must be submitted to State Bar of Texas)
Tuesday 07/18/17	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00 a.m.
Monday 07/24/17	**SBOT Chair and Treasurer Training** Texas Law Center 1414 Colorado St. Austin, TX 78701 10:30 a.m. – 2:30 p.m.
August 2017	
Friday 08/04/17	**Meeting of Council, Committee Chairs, and Committee Vice Chairs** Norton Rose Fulbright US LLP 1301 McKinney, Suite 5100 Houston, Texas 77010 (48th Floor) 10:30 a.m. – 12:30 p.m. w/lunch Dial In: 866-203-7023 Conference Code: 713-651-5591# Security Passcode: None – at the prompt press *
Thursday, 08/10/17	**Officer's Meeting** 4:00 p.m.

Thur – Tues 08/10/17 – 08/15/17	**American Bar Association Annual Meeting** New York Hilton Midtown, New York City, New York
Tuesday 08/15/17	**Government Submissions (COGS) Call with Committee Chairs** Dial –in: 800-525-8970; Conference Code 2143975538# Henry Talavera 9:00-9:30 a.m.
Thur – Fri 08/17/17 – 08/18/17	**Advanced Tax Law Course** Hilton Houston Post Oak, Houston, Texas
Sept 2017	
Friday 09/01/17	**Deadline for Submissions to State Bar of Texas Board of Directors Meeting Agenda**
Monday 09/04/17	**Labor Day Holiday**
Friday 09/15/2017	**Deadline for Appointment of Tax Section Nominating Committee**
Monday 09/15/17	**Submission Deadline – Texas Tax Lawyer (Fall Edition)** Submit to TTL Editor: Michelle Spiegel michelle.spiegel@nortonrosefulbright.com
Thur - Sat 09/14/17 – 0916/17	**American Bar Association Section of Taxation Joint Fall CLE Meeting** Hilton Austin, Austin Texas
Monday 09/18/17	**Tax Court Pro Bono Calendar Call-Houston**
Tuesday 09/19/17	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00-9:30 a.m.
Wed - Fri 09/20/17 – 09/22/17	**Rosh Hashanah (Religious Holiday)**
Thursday 09/21/17	**Comptroller Annual Meeting Briefing** Either Travis building or Stephen F. Austin office building (venue to be established)
Wednesday 09/27/17	**Officer's Meeting** 4:00 p.m.
Fri - Sat 09/29/17 – 09/30/17	**Yom Kippur (Religious Holiday)**

Oct 2017	
Monday 10/02/17	**Tax Court Pro Bono Calendar Call-Dallas**
Thur - Fri 10/05/17 – 10/06/17	**Sukkot (Religious Holiday)**
Monday 10/09/17	**Columbus Day Holiday**
Thursday 10/12/17	**Officer's Meeting** 4:00 p.m.
Monday 10/16/17	**Tax Court Pro Bono Calendar Call-El Paso**
Tuesday 10/17/17	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00-9:30 a.m.
Wednesday 10/18/17	**Outreach to Law Schools/SMU Dedman School of Law**
Thursday 10/19/17	**Tax Court Pro Bono Calendar Call-Lubbock**
Thursday 10/19/17	**Outreach to Law Schools/Texas Tech School of Law**
Sun - Wed 10/22/17 – 10/25/17	**Council on State Taxation (COST) 48th Annual Meeting** Orlando, Florida
Friday 10/27/17	**Council of Chairs Meeting** Texas Law Center 1414 Colorado St. Austin, TX 78701 10:30 a.m. – 2:30 p.m.
????	**National Association of State Bar Tax Sections ("NASBTS") Annual Meeting**
Monday 10/30/17	**Tax Court Pro Bono Calendar Call-Dallas**

Nov 2017	
Thursday 11/02/17	**20th Annual International Tax Symposium** Cityplace Events Dallas, TX 8:00 a.m.-5:00 p.m. followed by networking reception
Friday 11/03/17	**20th Annual International Tax Symposium** **Co-Sponsored with the University of Houston Law Center** University of Houston Student Center South, 4455 University Drive Houston, TX 77204 8:00 a.m.-5:00 p.m. followed by a networking reception
Wednesday 11/08/17	**Webinar "International Tax Law In A Day"** 8:30 a.m. – 2:00 p.m.
Thursday 11/09/17	**Webcast "International Tax Symposium"** 8:00 a.m. – 5:00 p.m.
Thursday 11/09/17	**Officer's Meeting** 4:00 p.m.
Friday 11/10/17	**Veterans Day Holiday**
Monday 11/13/17	**Tax Court Pro Bono Calendar Call-Houston**
Mon - Tues 11/13/17 – 11/14/17	**Austin Chapter CPA Annual Tax Conference**
Friday 11/17/17	**Meeting of Council** Norton Rose Fulbright US LLP 1301 McKinney, Suite 5100 Houston, Texas 77010 (Floor TBD) 10:30 a.m. – 12:30 p.m. w/lunch Dial In: 866-203-7023 Conference Code: 713-651-5591# Security Passcode: None – at the prompt press *
Friday 11/17/17	**Annual Meeting Deadline for submitting to SBOT date and time preferences for CLE programs, section meetings, council meetings, socials and special events**
Tuesday 11/21/17	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00-9:30 a.m.

Thursday 11/23/17	**Thanksgiving Day Holiday**
Monday 11/27/17	**Tax Court Pro Bono Calendar Call-Dallas**
Dec. 2017	
Tuesday 12/12/17	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00-9:30 a.m.
Tuesday 12/12/17	**COST Regional Meeting** Atlanta, Georgia
Wed - Fri 12/13/17 – 12/15/17	**UT Law Annual Taxation Conference**
Wed - Wed 12/13/17 – 12/20/17	**Chanuka (Other Holiday)**
Thursday 12/14/17	**Officer's Meeting** 4:00 p.m.
Monday 12/25/17	**Christmas (Other Holiday)**
Jan. 2018	
Monday 01/01/18	**New Year's Day Holiday**
?	**New Advanced Tax CLE Offering (Details TBD)**
?	**Nomination Period Opens for 2017 Outstanding Texas Tax Lawyer Award** • Nominations due April 1, 2018 • Nomination forms to be posted on website and distributed via eblast • Submit nomination forms to Tax Section Secretary: Christi Mondrick
Thursday 01/11/18	**Officer's Meeting** 4:00 p.m.
Friday 01/12/18	**Leadership Academy application due for the 2018-2019 class**
Friday 01/12/18	**Submission Deadline – Texas Tax Lawyer (Winter Edition)** Submit to TTL Editor: Michelle Spiegel michelle.spiegel@nortonrosefulbright.com

Friday 01/12/18	**Deadline for receipt of information for SBOT Board of Director's Meeting Agenda**
Friday 01/12/18	**Annual Meeting Deadline: Submit programming for the registration brochure, CLE topics, speakers, and speaker contact information and firms**
Monday 01/15/18	**Martin Luther King Jr. Day (Holiday)**
?	**Application Period Opens for Law Student Scholarship Program**
Friday 01/19/18	**Meeting of Council, Committee Chairs, and Committee Vice Chairs** Norton Rose Fulbright US LLP 1301 McKinney, Suite 5100 Houston, Texas 77010 (Floor TBD) 10:30 a.m. – 12:30 p.m. w/lunch Dial In: 866-203-7023 Conference Code: 713-651-5591# Security Passcode: None – at the prompt press *
?	**Leadership Academy Class of 2018-2019 Announced**
Tuesday 01/23/18	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00-9:30 a.m.
Feb. 2018	
Thursday 02/01/18	**Register and make guest room reservations for Annual Meeting (www.texasbar.com/annualmeeting)**
Friday, 02/09/18	**Tax Law in a Day CLE** Location: Houston (Location TBD)
Thur - Sat 02/08/18 – 02/10/18	**American Bar Association Section of Taxation Midyear Meeting** Hilton San Diego, San Diego CA
Thursday 02/15/18	**Officer's Meeting** 4:00 p.m.
Monday 02/19/18	**George Washington's Birthday (Holiday)**
Tuesday 02/20/18	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00-9:30 a.m.

Wednesday 02/21/18	**International Fiscal Association Oil & Gas Meeting** Houston, Texas
Wednesday 02/21/18	**Outreach to Law School/Baylor Law School**
Thur - Fri 02/22/18 – 02/23/18	**International Fiscal Association Annual Conference** Houston, Texas
Friday 02/23/18	**Council of Chairs Meeting and Section Representative Election** Texas Law Center 1414 Colorado St. Austin, TX 78701 10:30 a.m. – 2:30 p.m.
March 2018	
Thursday 03/01/18	**Nomination Deadline for Chair-Elect, Secretary, Treasurer, and 3 Elected Council Members**
Friday 03/02/18	**Annual Meeting Deadline: Order special awards, council and chair plaques, food and beverage and audio visuals**
Sun - Wed 03/04/18 – 03/07/18	**Annual Meeting of Unclaimed Property Professionals Organization (UPPO)** Tampa, Florida
Thursday 03/08/18	**Officer's Meeting** 4:00 p.m.
Tuesday 03/20/18	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00-9:30 a.m.
Thur - Fri 03/22/18 – 03/23/18	**Leadership Academy Austin Session** Location TBD
?	**Property Tax Committee Meeting and Legal Seminar** Location: TBD
03/30/18 – 04/01/18	**Good Friday, Passover, Easter Sunday (Religious Holiday)**
April 2018	
??	**Nominations for Outstanding Texas Tax Lawyer Due to Charolette Noel** Email**:** (cfnoel@jonesday.com)
?	**Law Student Scholarship Application Deadline**
?	**Nominating Committee Report Due to Council**

Thursday 04/12/18	**Officer's Meeting** 4:00 p.m.
April 04/13/18	**Submission Deadline – Texas Tax Lawyer (Spring Edition)** Submit to TTL Editor: Michelle Spiegel michelle.spiegel@nortonrosefulbright.com
Tuesday 04/17/18	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00-9:30 a.m.
Friday 04/20/18	**Meeting of Council** Norton Rose Fulbright US LLP 1301 McKinney, Suite 5100 Houston, Texas 77010 10:30 a.m. – 12:30 p.m. w/lunch Dial In: 866-203-7023 Conference code: 713-651-5591# Security passcode: None - at the prompt press * <u>Note: Council Vote and Selection of Recipient of 2017 Outstanding Texas Tax Lawyer Award</u>
Friday 04/20/18	**Council Vote and Selection of Recipient of 2017 Outstanding Texas Tax Lawyer Award**
Friday 04/27/18	**Annual Meeting Deadline: course materials for app; CLE articles, PowerPoints, speaker bios and photos**
May 2018	
Thur - Sat 05/10/18 – 05/12/18	**American Bar Association Section of Taxation May Meeting** Grand Hyatt, Washington, DC
Tuesday 05/15/18	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00-9:30 a.m.
?	**Pro Bono Calendar Call – San Antonio**
?	**Pro Bono Calendar Call – Houston**
?	**Pro Bono Calendar Call – Dallas**
Thursday 05/17/18	**Officer's Meeting** 4:00 p.m.
Monday 05/28/18	**Memorial Day Holiday**

June 2018	
?	**Pro Bono Calendar Call - Houston**
??	**Annual Texas Federal Tax Institute** Hyatt Hill Country Resort San Antonio, TX
Thursday 06/14/18	**Officer's Meeting** 4:00 p.m.
Tuesday 06/19/18	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 800-525-8970; Conference Code: 2143975538# Henry Talavera 9:00-9:30 a.m.
Wed - Fri 06/20/18- 06/22/18	**Leadership Academy Houston Session (With Annual Meeting)** Marriott Marquis Hotel 1777 Walker Street Houston, Texas 77010 (713) 654-1777 5:00 p.m. – 8:00 p.m.
Thur - Fri 06/21/18 – 06/22/18	**SBOT Annual Meeting** Location TBD Houston, TX
Thursday 06/21/18	**Tax Section Council Planning Retreat** Location TBD Houston, TX 1:00 p.m. - 4:00 p.m.
Thursday 06/21/18	**2018 Tax Section Annual Meeting Speaker's Dinner** Location: TBD Houston, TX
Thursday 06/21/18	**Presentation of Outstanding Texas Tax Lawyer** Award Presentation at State Bar Annual Meeting, Speakers' Dinner Location TBD
Friday 06/22/18	**2018 Tax Section Annual Meeting Program** Location: Marriott Marquis Houston, TX
Friday 06/22/18	**Presentation of 2018 Tax Legend Award** Award Presentation During Tax Section Annual Meeting Program Location: Marriott Marquis Houston, TX

TAX SECTION

STATE BAR OF TEXAS

LEADERSHIP ROSTER

2017-2018

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TAX SECTION
THE STATE BAR OF TEXAS
COMMITTEE CHAIRS AND VICE CHAIRS
2017-2018

COMMITTEE		CHAIR	VICE CHAIR
1.	**Annual Meeting**	**John Strohmeyer** Crady, Jewett & McCulley, LLP 2727 Allen Pkwy., Suite 1700 Houston, Texas 77019 *(713) 739-7007* jstrohmeyer@cjmlaw.com	N/A (Planning Committee)
2.	**Continuing Legal Education**	**Dan Baucum** Munsch Hardt 500 N. Akard Street Suite 3800 Dallas, Texas 75201 *(214) 855-7509* dbaucum@munsch.com **Lora G. Davis** Davis Stephenson, PLLC 100 Crescent Court, Suite 440 Dallas, Texas 75201 *(214) 396-8802* lora@davisstephenson.com **Michael Threet** Haynes and Boone, LLP 2323 Victory Avenue, Suite 700 Dallas, TX 75219 *214-65-5091* michael.threet@ haynesboone.com **Amanda Traphagan** Seay & Traphagan 807 Brazos St., Suite 304 Austin, Texas 78701 *(512) 582-0120* atraphagan@seaytaxlaw.com	**Jim Roberts** Glast, Phillips & Murray, PC 14801 Quorum Dr., Suite 500 Dallas, Texas 75254 *(972) 419-7189* jvroberts@gpm-law.com

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