The Texas Tax Lawyer

February 2006
Vol. 33, No. 2
www.texastaxsection.org

STATE BAR OF TEXAS

2006

Created in 1939

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CHAIR'S MESSAGE

We're off to a great start for the year thanks to successes in our governmental submissions initiative, continuing legal education programs, and new committees, each of which is highlighted below. First, the Section delivered to the Treasury comments on the Section 83 proposed regulations. These comments have been well received. The Assistant Secretary of the Treasury for Tax Policy personally thanked the Section for its contribution and encouraged its continued participation in this process. Other national bar associations have been complementary of the Section's efforts as well. James Howard, Robert Phillpott and Brandon Jones, as the Chair and Vice Chairs, respectively, of the Partnership/Real Estate Committee, took the lead in the preparation of the Section's comments. They, together with the Committee on Governmental Submissions, deserve special recognition for our successful first steps in this arena. These comments are included in this edition of *The Texas Tax Lawyer*.

Our initiative regarding governmental submissions is just beginning, however, and the long-term success of this effort will depend on our Committees to quickly identify and respond to new opportunities for submissions. I hope each of you will participate in this process. If you are not currently a member of a Committee, please take the time to complete the Committee Selection Form included in this edition.

Second, CLE programs remain a primary activity of the Section. Since July, we've had three very successful programs: the Advanced Tax Law Course held in Dallas on September 29 and 30 (course director, Dan Baucum), with video replay in Houston on October 27 and 28; the Eighth Annual International Symposium held in Dallas on November 4 (course director David Peck); and the Texas Tax Controversy Course held in Houston on December 2 (course director Christi Mondrik). I would like to thank the course directors and their planning committees and faculty for a job well done. Outlines for these programs should be posted on the Section's website as soon as the materials become available. Please mark your calendars now for the Texas Federal Tax Institute to be held in San Antonio on June 8 and 9. This year's program promises to be another outstanding review of current topics in corporate and partnership tax law.

Third, the Section added two new committees this year, the Pro Bono Committee and Solo/Small Firm Committee. Our new Pro Bono Committee, lead by Dan Micciche, had its first meeting on November 14 with 15 committee members participating. Information on the Committee is included elsewhere in this edition. Regardless of whether you join the Committee, you can still participate in their pro bono efforts through the Volunteer Income Tax Assistance program or the Texas Community Building with Attorney Resources program. To learn more about these activities, contact Dan Micciche, Chair, at dmicciche@akingump.com or Janet Jardin, Vice Chair, at janet.jardin@tklaw.com.

The Solo/Small Firm Committee held its first meeting on September 6. David Adler, Chair of the Committee, reports that the Committee is looking at a number of exciting projects including alternatives for delivering continuing legal education in a less expensive and more timely manner for solo and small firm practitioners. If you are interested in participating in this Committee, please contact David at adlerpc@swbell.net.

Regarding the Section's Outstanding Texas Tax Lawyer award, it is my pleasure to announce that the Council has made the award for 2005/2006 to Charles W. Hall. This honor is a lifetime achievement award in recognition of the recipient's expertise and professionalism within the Tax Bar, participation in local, state and national bar associations and other legal fraternities, reputation for ethics, and mentoring of other tax professionals. Since 2002, when the Section first established the award, it has been issued only once in 2002/2003 to Vester T. Hughes. We are fortunate to have members with the character and intellect of these men. The Section will formally present the award to Charles at the Texas Federal Tax Institute in San Antonio on June 8 and 9.

Finally, we've all witnessed the personal tragedies of those impacted by Hurricanes Katrina and Rita. What is less visible but just as real are the resulting legal problems for those affected. Legal assistance for the poor affected by those tragedies has overwhelmed the State's legal aid programs. The Texas Access to Justice Commission (TATJC), organized by the Texas Supreme Court to expand access in civil legal matters to low income persons, has requested monetary assistance from both the Section and its members to help fund various legal aid programs throughout the State. In view of this extraordinary demand on our legal aid programs, the Council made a $5,000 contribution to the Texas Equal Access to Justice Foundation. You may learn more about the TATJC by visiting their website at www.texasatj.org. TATJC's letter to the Section members is available for review on the Section's website. Your contributions in response to the TATJC request may be made to either the Texas Equal Access to Justice Foundation or the Texas Bar Foundation.

Bill Bowers

THE SOLO/SMALL FIRM TAX PRACTICE COMMITTEE

The State Bar of Texas Tax Section established the Solo/Small Firm (S/SF) Tax Practice Committee to help channel resources of the Tax Section to the needs of solo and small firm tax lawyers.

If you have an interest, please participate by joining the committee.

To learn more about the S/SF committee, or to make suggestions for our committee to pursue, **please contact David Adler, Chairman, at adlerpc@swbell.net or (214) 521-7203.**

– WE NEED YOUR INPUT –

CALL FOR NOMINATIONS FOR
OUTSTANDING TEXAS TAX LAWYER AWARD

The Council of the Section of Taxation is soliciting nominees for the Outstanding Texas Tax Lawyer Award. Please describe the nominee's qualifications using the form below. Nominees must: be a member in good standing of the State Bar of Texas or an inactive member thereof; have been licensed to practice law in Texas or another jurisdiction for at least ten years; and have devoted at least 75 percent of his or her law practice to taxation law.[1] In selecting a winner, the Council will consider a nominee's reputation for expertise and professionalism within the community of tax professionals specifically and the broader legal community; authorship of scholarly works relating to taxation law; significant participation in the State Bar of Texas, American Bar Association, local bar associations, or legal fraternities or organizations; significant contributions to the general welfare of the community; significant pro bono activities; reputation for ethics; mentorship of other tax professionals; experience on the bench relating to taxation law; experience in academia relating to taxation law; and other significant contributions or experience relating to taxation law.

Nominations should be submitted to Bill Bowers, either by email (bbowers@fulbright.com) or hardcopy (fax number 214-855-8200) no later than June 30, 2006. The award will be made at the 2006 Advanced Tax Law course in September.

NOMINATION FOR OUTSTANDING TEXAS TAX LAWYER AWARD

Nominee Name: ____

Mailing Address: ____

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Description of Nominee's Contributions/Experience Relating to Taxation Law:

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1 "Law practice" means work performed primarily for the purpose of rendering legal advice or providing legal representation, and also includes: service as a judge of any court of record; corporate or government service if the work performed was legal in nature and primarily for the purpose of providing legal advice to, or legal representation of, the corporation or government agency or individuals connected therewith; and the activity of teaching at an accredited law school; "Taxation law" means "Tax Law" as defined by the Texas Board of Legal Specialization's standards for attorney certification in Tax Law; tax controversy; employee benefits and executive compensation practice; criminal defense or prosecution relating to taxation; taxation practice in the public and private sectors, including the nonprofit section; and teaching taxation law or related subjects at an accredited law school.

CANDIDATE QUESTIONNAIRE
FOR OFFICER OR COUNCIL MEMBER - STATE BAR OF TEXAS TAX SECTION

Name: ____________________

Firm Name: ____________________

Address: ____________________

City, State, Zip: ____________________

Email address: ____________________

Position: ____________________

Describe your involvement in the State Bar of Texas:

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Describe your involvement in other Bar activities:

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Describe other relevant experience for the position:

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Please email completed form to Bill Bowers at bbowers@fulbright.com

SECTION OF TAXATION OF THE STATE BAR OF TEXAS

2005-2006 CALENDAR

July	
13	New Chair/Treasurer Orientation - Texas Law Center, Austin
15	Quarterly dues check mailed to Section Treasurer
24	Chair: Appoint Nominating Committee
29-30	SBOT Bar Leaders Conference - Omni Mandalay, Las Colinas
August	
1	SBOT Board Advisors: Reminder to committee/section chairs action requiring Board approval for September 23, 2005 Board meeting is due September 9, 2005
10	Texas Bar Foundation grant application deadline
12	Deadline for submitting articles for the October 2005 issue of the Texas Tax Lawyer
12	Chair: Submit names of Nominating Committee members for publication in Texas Tax Lawyer
31	Deadline for SBOT Dues, Texas Occupation Tax and Legal Services Fee
September	
1	Chair: Select Annual Meeting program chair and inform State Bar Annual Meeting coordinator
9	Deadline for receipt of data included in packets for September 23 SBOT Board of Directors meeting
16	Council of Chairs Meeting - Texas Law Center, Austin
15-17	ABA Section of Taxation Fall Meeting - San Francisco, CA
23	SBOT Board of Directors Meeting - Ambassador Hotel, Amarillo
29-30	23rd Annual Advanced Tax Law Course - Dallas
October	
2	Annual Meeting program chair: Select program and proposed speakers for SBOT Annual Meeting in 2006
15	Quarterly dues check mailed to Section Treasurer
27-28	23rd Annual Advanced Tax Law Course (Video) - Houston

November	
18	10:30 A.M. - 12:30 P.M. Council Meeting Fulbright & Jaworski 2200 Ross Avenue, Suite 2800 Dallas, Texas 75201 (214) 855-8000
21	New Lawyer's Induction Ceremony - Frank Erwin Center, Austin
December	
9	Deadline for submitting articles for the February 2006 issue of the Texas Tax Lawyer
12	Chair: Prepare section mid-year report (due Jan. 6)
January	
6	Deadline for receipt of data for January 20 SBOT Board of Directors meeting
13	Council of Chairs Meeting - Texas Law Center, Austin
15	Quarterly dues check mailed to Section Treasurer
20	SBOT Board of Directors Meeting – Icon Hotel, Houston
27	10:30 a.m. – 12:30 p.m. Council/Committee Chairs Meeting **MANDATORY IN PERSON ATTENDANCE BY ALL COUNCIL MEMBERS AND EITHER CHAIR OR VICE CHAIR** Fulbright & Jaworski 2200 Ross Avenue, Suite 2800 Dallas, Texas 75201 (214) 855-8000
February	
2-4	ABA Section of Taxation Midyear Meeting – San Diego, CA
March	
1	Filing deadline for nominating petitions for SBOT and TYLA Director and President—elect positions
1	Deadline for receipt of nominations for Presidents' Award
3	Nominating Committee: Present nominations to the Council
3	10:30 A.M. - 12:00 P.M. Council Meeting Fulbright & Jaworski 2200 Ross Avenue, Suite 2800 Dallas, Texas 75201 (214) 855-8000

12	Nominating Committee: Publish nominations for Council members in the Texas Tax Lawyer
12	Deadline for submitting articles for the May 2006 issue of the Texas Tax Lawyer
27	Annual Meeting program chairs: Send information to State Bar for promotional Section flyers and Annual Meeting registration form
April	
1	Annual Meeting program chair: Annual Meeting hotel arrangements for guest speakers due
3	Deadline for SBOT Annual Meeting resolutions
7	Deadline of receipt of data to be included for April 21 Board of Directors meeting
14	Council of Chairs Meeting – Texas Law Center, Austin
15	Quarterly dues check mailed to Section Treasurer
15	Chair: Prepare section end-of-the year report for publication in July Bar Journal
21	SBOT Board of Directors Meeting – Sheraton Four Points Hotel, Brownsville
May	
1	Annual SBOT due statements mailed
4-6	ABA Section of Taxation May Meeting – Washington, D.C.
12	Council: Elect Chair-Elect, Secretary and Treasurer for 2006/2007 fiscal year
12	10:30 a.m. – 12:30 p.m. Council/Committee Chairs Meeting **MANDATORY IN PERSON ATTENDANCE BY ALL COUNCIL MEMBERS AND EITHER CHAIR OR VICE CHAIR** Fulbright & Jaworski 2200 Ross Avenue, Suite 2800 Dallas, Texas 75201 (214) 855-8000
22	New Lawyers' Induction Ceremony – Frank Erwin Center, Austin
June	
1	Due date for 2006 SBOT Dues, Texas Occupation Tax and Legal Services Fee
2	Deadline for receipt of data for June 14-15 SBOT Board of Directors meeting
8-9	Texas Tax Institute – San Antonio
9	Council of Chairs Meeting – Texas Law Center, Austin
14-15	SBOT Board of Directors Meeting – Austin
14-17	SBOT Annual Meeting, Austin

JOIN THE NEW PRO BONO COMMITTEE

"I would like to help the needy, but there is no pro bono work for a tax lawyer."

Sound familiar?
Well, it is WRONG, and in fact, some pro bono projects are better suited for tax lawyers.

The State Bar of Texas Tax Section has a new Pro Bono Committee that is committed to providing a venue for tax lawyers to participate in pro bono activities.

We need your help.

Some of the projects that we will focus on include:

❖ The Volunteer Income Tax Assistance (VITA) program

VITA is designed to help low-income taxpayers claim the refundable earned income tax credit (EITC). The EITC is the largest cash assistance program for the working poor. And still, about 25% of eligible taxpayers fail to claim the credit because either they are not aware of the credit or it is too complex. Your efforts could help the working poor claim the EITC and lift them out of poverty.

VITA training sessions have already started! Please contact us for more information.

❖ The Texas Community Building with Attorney Resources (C-BAR) program

Texas C-BAR is a statewide pro bono initiative for transactional attorneys. Texas C-BAR provides free legal representation and other legal resources for community-based nonprofits working to improve the lives of low-income persons and transform distressed neighborhoods into healthy communities. The types of matters that Texas C-BAR refers to volunteer attorneys include: drafting articles of incorporation and bylaws; applying for and maintaining tax-exempt status; establishing joint ventures; drafting and reviewing contracts; and reviewing financing documents.

Remember—A pro bono tax lawyer is not an oxymoron.

To learn more about participating in these pro bono activities or being a member of the Pro Bono Committee, please contact Dan Micciche, Chair, at dmicciche@akingump.com or 214.969.2797 or Janet Jardin, Vice-Chair, at janet.jardin@tklaw.com or 214.969.1535.

TAX CONTROVERSY: RECENT DEVELOPMENTS

The following summary of selected current developments in the law applicable to tax controversies was prepared by Emily Parker for the Tax Controversy Committee of the Section of Taxation.[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.

Statute of Limitations

TEFRA Partnership Adjustments. The Court of Federal Claims in AD Global Fund LLC v. United States[2] held that section 6229(a), which generally provides a 3-year limitations period for assessing tax attributable to partnership items, operates to extend, but does not reduce, the general limitations period under section 6501(a).[3] Thus, this case reaches the same result as the Tax Court in Rhone-Poulenc Surfactants & Specialties, L.P. v. Comm'r,[4] and the D.C. Circuit in Andantech L.L.C. v. Comm'r,[5] but prior decisions of the Tax Court, the Second Circuit and the Fifth Circuit, in *dicta* and otherwise, reach the contrary conclusion. The court reasoned that the statutory language is ambiguous; the legislative history does not resolve that ambiguity; and, therefore, the ambiguity is resolved in favor of the Government, under the rule of statutory construction that a limitations statute barring collection of taxes otherwise due is construed in favor of the Government. The opinion includes a very extensive discussion of the rules of statutory construction and the use and weight to be given to various sources of legislative history.

The court later granted the taxpayer's motion to certify an interlocutory appeal of its decision.[6] The court found (i) that its decision resolved a controlling question of law; (ii) that there was a substantial ground for differences of opinion concerning the proper interpretation of section 6229(a); and (ii) that immediate appeal would materially advance termination of the litigation, not only in this case but also in other cases presenting the same issue.

Informal Claims for Refund. In Mobil Corp. v. United States,[7] the Court of Federal Claims held that Mobil failed to timely file a refund claim with respect to its Enhanced Oil Recovery (EOR) tax credits for 1997, but that Mobil had timely filed informal claims for refund for other claims (the non-EOR claims) for 1997.

The non-EOR claims were in Mobil's original 1997 return and were disallowed during the 1995-1997 return audit, but no assessment resulted because the resulting underpayment was offset by overpayments. Mobil argued that its 1997 return constituted a formal claim for refund and, alternatively, that the IRS examination established an informal claim for refund. Relying on Arch Engineering v. United States,[8] the IRS argued that the claims in the 1997 return did not satisfy the claim filing requirement because of tax refunds made prior to audit of that return. The court expressly did not decide whether Mobil's original 1997 return was a formal claim for refund. Instead, the court held that Mobil's 1997 return combined with the IRS examination of the claims established the three elements of a valid, informal claim: (i) notice to the IRS that a refund is sought, (ii) the factual and legal basis of the claim, and (iii) a written component. The court distinguished Arch Engineering because in that case all evidence of an informal claim related to periods before payment of the tax.

While Mobil did not file a formal EOR claim for 1997 until after expiration of the limitations period, it argued that it made an informal "missed costs" EOR claim when it submitted a 360-page document (the "Affirmative") to the audit team in the course of the 1995-1997 return audit. The court held that the Affirmative did not constitute a valid, informal claim because the 1995-1997 audit plan expressly stated that an Affirmative must be filed as a formal claim on Form 1120-X, and would not be treated as an informal claim if submitted after a specified date unless approved by the IRS case manager. There was no evidence that the case manager approved the late filing of the Affirmative. Therefore, the court held that Mobil did not file a timely informal "missed costs" EOR claim for 1997.

Mobil also argued that it made an informal "significant expansion" EOR claim for 1997, because (i) it informed the IRS audit team of such claim in a December 9, 1999 meeting, and (ii) an IRS Engineer examined the significant expansion issues for the years 1995-1997 while examining significant expansion EOR claims for the years 1991-1994. The court held that the December 9, 1999 meeting did not constitute in informal claim since, at that meeting, Mobil stated that it planned to submit a claim in the future and the IRS did not have sufficient information to examine any claim at that time. The court acknowledged that from Mobil's perspective, it appeared that an IRS engineer subsequently examined the 1997 significant expansion claim as part of her examination of a similar claim for 1991-1994. Information requested by the IRS engineer relating to 1995-1997, however, also might be relevant to examination of similar claims for 1991-1994. There was no duly authorized open audit of the 1995-1997 significant expansion claim, and the IRS engineer did not have the authority to open such an examination. Therefore, the court concluded that even if the IRS engineer had actual knowledge that Mobil was asserting an unequivocal, present claim for refund for 1997, her knowledge cannot be imputed to the IRS, so Mobil did not make a valid, informal significant expansion EOR claim for 1997.

Tax Court Jurisdiction

Interest. Reversing the Tax Court, the Fifth Circuit in *Estate of Smith v. Comm'r*[9] held that the Tax Court did not have jurisdiction to order the IRS to refund the "overpayment" reflected in the Tax Court's prior decision without reduction for assessed, but unpaid, underpayment interest. The Fifth Circuit rejected the Tax Court's conclusion that the "overpayment" necessarily included underpayment interest, and reasoned that section 7481(c)[10] would have been unnecessary if all Tax Court decisions reflecting an "overpayment" included a determination of interest. The Fifth Circuit recognized that if interest actually had been properly incorporated in the Tax Court's prior decision, it would have jurisdiction to order refund of that overpayment.[11] The Fifth Circuit reviewed the stipulations and computations for entry of the Tax Court decision and held that, in fact, the Estate's liability for underpayment interest was not decided in determining the Estate's overpayment as reflected in the decision. As a result, the Tax Court exceeded its jurisdiction when it ordered the IRS to refund the full amount of the overpayment reflected in the decision, since section 6512(b)(4) provides that the Tax Court does not have jurisdiction to review any credit or reduction of an overpayment made by the IRS pursuant to section 6402. (See discussion of district court jurisdiction of overpayment

interest claim below.) *Comment:* The Tax Court's decision in Estate of Smith presents the question of how to deal with interest when the parties agree to an "overpayment" in a Tax Court decision, at least where appeal lies to a circuit other than the Fifth Circuit.

Section 6652(c)(1)(A) Penalty. In Service Employees Int'l Union v. Comm'r,[12] the Tax Court held that it does not have jurisdiction under section 6330(d)(1) to review lien and levy determinations with respect to the penalty imposed by section 6652(c)(1)(A) on an exempt organization for failure to file its annual return. Since the Tax Court does not have jurisdiction over section 6652(c)(1) penalties, it does not have jurisdiction to review collection due process (CDP) determinations with respect to those penalties under section 6330(d)(1)(A) and (B). The Tax Court distinguished Downing v. Comm'r,[13] which held that the Tax Court had jurisdiction to review CDP determinations with respect to additions to tax under section 6651(a)(2) for failure to timely pay income, gift or estate taxes, since it has jurisdiction over income, gift and estate taxes and calculation of the additions to those taxes are tied to the underlying tax liability. By contrast, the penalty under section 6652(c)(1) is not tied to the amount of tax due but accumulates at a flat daily rate. The Tax Court rejected the Union's "policy" argument that since the Tax Court has jurisdiction over other aspects of its tax-exempt status, it also should have jurisdiction to review CDP determinations with respect to the section 6652(c)(1) penalty.

Employment Tax Liability. In Charlotte's Office Boutique, Inc. v. Comm'r,[14] the Ninth Circuit held that the Tax Court had jurisdiction to review the IRS's determination of the taxpayer's employment tax liability on amounts paid as "royalties," even though there was no dispute that the recipient was the taxpayer's employee for employment tax purposes. The taxpayer paid its shareholder, Odell, wages subject to employment taxes for the years 1996-1998, and also paid her "royalties" for 1995-1998. The IRS issued a Notice of Determination Concerning Worker Classification Under Section 7436 for the years 1995 through 1998, stating that Odell was the taxpayer's employee and that the royalties were actually wages. The taxpayer filed a petition for redetermination. After trial, the IRS filed a motion to dismiss for the years 1996-1998, on the basis that there was no controversy that Odell was taxpayer's employee, so the Tax Court lacked jurisdiction under section 7436(a). The Tax Court ruled that it had jurisdiction, that Odell was an employee for all years, and that the royalty payments were wages subject to employment taxes. Both the IRS and the taxpayer appealed the jurisdictional ruling, and the taxpayer appealed the decision that the royalties were wages. The Ninth Circuit held that under section 7436(a) the Tax Court has jurisdiction to review both the IRS's determination of employee status and "the proper amount of employment tax under such determination," and that the Tax Court does not lose such jurisdiction even though the IRS and the taxpayer agree as to employee status. The IRS apparently wanted to restrict the Tax Court's jurisdiction so that the statute of limitations on assessment of employment taxes for 1996-1998 would not run while the case was pending in the Tax Court, since the taxpayer reported amounts as wages subject to employment tax for those years. The Ninth Circuit rejected that argument based on the terms of section 7436(a), and further noted that restricting the Tax Court's jurisdiction in this manner would not resolve the IRS's dilemma and that the IRS has other means for resolving its dilemma.

Levy on State Tax Refund. The Tax Court in Clark v. Commissioner,[15] held that it has jurisdiction to review the Commissioner's determination regarding a levy on a taxpayer's state tax refund under section 6630. Section 6330(d) provides for judicial review of such determinations, stating that a taxpayer may within 30 days of a determination under this section, appeal such determination to the Tax Court. Section 6330(f) provides that "this section" shall not apply in the case of a jeopardy levy or a levy on a state tax refund. In Dorn v. Commissioner,[16] the Tax Court held that section 6330(f) merely made the notice requirement of section 6330(a) inapplicable to jeopardy levies, rather than divesting the Tax Court of jurisdiction to review such cases. In Clark, the Tax Court extended this decision to a levy on a state tax refund.

District Court Jurisdiction - Overpayment Interest

In The E.W. Scripps Co. v. United States,[17] the Sixth Circuit held that the district court had jurisdiction under section 1346(a)(1) over a claim for overpayment interest in excess of $10,000, where there was no separate claim for refund of overpaid tax.[18] The Government argued that exclusive jurisdiction of such claim rested in the Court of Federal Claims, relying on section 6611 which does not treat overpayment interest as part of the overpaid tax, as contrasted with section 6601(e)(1), which expressly treats deficiency interest as tax. The Sixth Circuit acknowledged that overpayment interest may not be included in "any internal-revenue tax" for purposes of section 1346(a)(1), but concluded that overpayment interest is "any sum alleged to have been excessive . . . under the internal-revenue laws" as provided in section 1346(a)(1). The Sixth Circuit recognized that section 7422(a) (which requires the filing of an administrative refund claim as a condition to filing a suit for refund and uses language that is identical to the language of section 1346(a)(1)) has been interpreted not to apply to a suit for overpayment interest.[19] The court concluded, however, that the two provisions serve different functions and may have different meanings, so that overpayment interest comes under the "any sum" language of section 1346(a)(1), even though it "might not" fall within the scope of section 7422(a). *Comment:* The Sixth Circuit's statement that overpayment interest "might not" fall within the scope of section 7422(a) could be used to argue that, contrary to prior decisions, the claim requirements of section 7422(a) apply to claims for overpayment interest.

Section 6110 - Public Disclosure

Section 6110 and Attorney Workproduct. Tax Analysts v. IRS[20] is the latest case involving requests by Tax Analysts for disclosure of documents that the IRS has refused to disclose based on the attorney work product doctrine. A prior case[21] (referred to as the "Guidance case") held that, in response to a FOIA request, the IRS could refuse to disclose, in their entirety, Technical Assistance memoranda prepared by Chief Counsel attorneys in preparation for trial, even though they reflected agency working law. In this case, Tax Analysts requested disclosure of Chief Counsel Advice (CCA) under section 6110, arguing that the Guidance case does not control because it was a FOIA case.[22] Section 6110 requires the IRS to make its "written determinations," including CCA, available for public inspection, except that the IRS has discretion to delete material from CCA in accordance with exemptions available under the FOIA, including Exemption 5 which incorporates the traditional attorney work product doctrine. The court held that the FOIA precedent regarding Exemption 5 applied to a request for disclosure under section 6110. After an *in camera* inspection of the CCA

documents in issue, the district court concluded that the CCA were attorney work product and that their disclosure, in whole or in part, would reveal the IRS's litigating strategy, as well as the thought processes, of the attorneys advising and representing the IRS in the litigation. Therefore, the court refused to order disclosure of the requested CCA, noting that the IRS could, in its discretion, disclose the CCA, in whole or in part.

The district court also refused to order disclosure of taxpayer identifying information that the IRS had redacted from "check sheets" and "harm memos" relating to the CCA based on section 6103.[23] The court rejected Tax Analysts' argument that the taxpayers had waived their section 6103 protection by filing petitions in the Tax Court. The court held that disclosure of the taxpayer identifying information would disclose information not in the public record in the Tax Court cases, including that the taxpayer's case was the subject of CCA.

No Right to CCA. In Ullman v. United States,[24] the Federal Circuit held that a taxpayer does not have a right to receive legal advice from the IRS, and that section 6110 does not require the IRS to issue rulings for a requesting taxpayer. The taxpayer claimed that the IRS failed upon request to provide him with CCA, as required by section 6110 and in violation of his installment agreement with the IRS. The court held that an oral agreement cannot vary the terms of an installment agreement, and that section 6110 requires the IRS to disclose CCA that has actually been issued, but does not give a taxpayer a right to request or to receive legal advice from the IRS.

Fifth Amendment Privilege

In United States v. Marra,[25] Marra was an accountant who was both a tax return preparer and third-party record keeper for an individual and for corporate entities owned by that individual and his father-in-law. The IRS issued a summons to Marra to give testimony and to produce books, records, papers and other data in connection with an investigation of the filing of false and fraudulent returns or attempted tax evasion by the target individual. Marra declined to produce the requested documents and to give testimony with respect to the documents produced, asserting his Fifth Amendment privilege against self-incrimination. The court found that Marra was a third-party record keeper for the target individual, or a custodian of corporate records, and that the Fifth Amendment privilege did not apply. The court rejected Marra's argument that he could personally assert a Fifth Amendment privilege. The court also refused to stay enforcement of the summons pending appeal on the basis that Marra was not likely to succeed on the merits of the appeal.

In refusing to stay enforcement, the court held that a custodian of corporate records may not invoke the Fifth Amendment to avoid producing and authenticating those records, even where production of those documents would be personally incriminating. However, the court recognized that some uncertainty exists whether the act of producing records may have a testimonial aspect and whether a custodian of records can be compelled to testify regarding those records. The court distinguished United States v. Hubbell[27] on the basis that (i) Hubbell was under investigation and the one compelled to testify; (ii) Hubbell was asked to produce his personal records; and (iii) the prosecutor had no independent knowledge of the wrongdoing or the documents. In addition, the court distinguished Hubbell on the basis that the IRS summons to Marra specifically requested documents used in the preparation of returns, so that Marra was not required to make relational determinations regarding the documents.

The court repeatedly emphasized that Marra was not under criminal investigation. It recognized, however, that Marra could be the target of criminal charges for preparing false or fraudulent returns, and that Marra was claiming that the summoned documents belonged to him personally. The Government argued that Marra did not properly claim any personal Fifth Amendment privilege because he did not appear with the documents and claim the privilege on a question-by-question basis. Marra had asked to appear before the IRS for this purpose in response to the summons, but the IRS did not respond to this request before filing to enforce the summons. The court concluded that since Marra had failed to appear with the documents to claim privilege in response to the court's enforcement order, he had failed to properly claim any personal Fifth Amendment privilege he might have with respect to the documents, so that Marra was not likely to succeed on any appeal of the enforcement order.

Ballard v. Comm'r - Tax Court Rule 183(a)

In Ballard v. Comm'r,[28] the Supreme Court held that the Tax Court violated T.C. Rule 183 when it excluded from the record on appeal a report prepared by a Special Trial Judge. On remand from the Supreme Court, the Eleventh Circuit in Ballard[29] struck the "collaborative report" that was the basis of the Tax Court's decision, reinstated the Special Trial Judge's report, and referred the case to a regular Tax Court Judge with no involvement in the "collaborative report" with directions to give due regard to the credibility determinations of the Special Trial Judge by presuming his factual findings are correct unless manifestly unreasonable. In Estate of Lisle v. Comm'r,[30] the Fifth Circuit, in a case related to Ballard, confirmed its prior holding that no fraud penalties should have been imposed, and remanded the case to the Tax Court under terms identical to the remand in Ballard, to determine whether there is a deficiency in the case.

In response to the Supreme Court's decision in Ballard, on August 19, 2005, the Tax Court issued orders in approximately 120 cases (or groups of related cases) previously tried by Special Trial Judges under T.C. Rule 183, attaching a copy of the Special Trial Judge's report in each case. The orders indicated that the decisions in all but three of the cases are final under section 7481.[31] Tax Court Chief Judge Gerber has publicly stated that there were four cases in which the result in the case differed from the result reached in the Special Trial Judge's report.[32] Effective September 20, 2005, the Tax Court announced the adoption of amendments to its Rules of Practice and Procedure, including procedures to be followed upon reassignment of a case from a Special Trial Judge to a regular Tax Court Judge in light of the Supreme Court's decision in Ballard.

Collection Due Process (CDP)

Proposed Regulations. On September 15, 2005, the Treasury issued two sets of proposed regulations to clarify the rules for CDP hearings under section 6320 in response to a notice of filing of federal tax lien, and under section 6330 in response to a notice of intent to levy.[33] The proposed regulations are effective 30 days after publication of final regulations in the Federal Register for requests for CDP hearings or equivalent hearings made on or after 30 days after publication of the final regulations. The IRS asks for

written comments on the proposed regulations, and a public hearing on the proposed regulations is scheduled for January 19, 2006.

Proposed changes to the current regulations include: (1) a requirement that taxpayers state, in writing, the reasons for their disagreement with the IRS action or proposed action; (2) a requirement that a taxpayer who does not sign the CDP request must affirm, in writing, the request within a reasonable time after a request from Appeals, or the taxpayer will be denied a CDP hearing; (3) a definition of "prior involvement" by the Appeals officer to exist only where the taxpayer, the tax liability and the tax period shown on the CDP notice were at issue in the prior non-CDP hearing, and the Appeals officer actually participated in the prior non-CDP hearing;[34] (4) a provision clarifying that a face-to-face conference is merely one aspect of a CDP hearing and is not itself the entire CDP hearing; (5) a provision that in all cases an Appeals officer will review the taxpayer's request for a CDP hearing, the case file, other written communications from the taxpayer, and any notices of oral communications with the taxpayer or the taxpayer's representative and, if no face-to-face conference is held, review of these documents will constitute the CDP hearing; (6) a provision clarifying that when a business taxpayer is allowed a face-to-face conference, it will be held at the Appeals office closest to the taxpayer's principal place of business; (7) a provision describing specific circumstances in which Appeals will not hold a face-to-face conference with the taxpayer or the taxpayer's representative because a conference will serve no useful purpose, including where the taxpayer raises only frivolous arguments concerning the tax system, where the taxpayer proposes collection alternatives that would not be available to other taxpayers in similar circumstances, or where the taxpayer does not provide a written request for a CDP hearing reflecting information required by the regulations; (8) a provision that the face-to-face conference will not be held at the location closest to the taxpayer's principal residence or place of business if all Appeals officers or employees in that location are considered to have prior involvement; (9) a provision to clarify that taxpayers who receive CDP hearings can only qualify for collection alternatives available generally to taxpayers in similar circumstances; (10) a provision clarifying that in order to obtain judicial review, a taxpayer must bring the issue to the attention of the Appeals officer and submit, if requested, evidence with respect to that issue; (11) a statement of the contents of the administrative record required for court review; (12) a provision that the IRS will notify taxpayers of their right to an equivalent hearing upon receipt of a late request for a CDP hearing and, if the taxpayer requests an equivalent hearing in response, the IRS will treat the CDP hearing request as a request for an equivalent hearing; (13) a provision that limits the time period for making a request for an equivalent hearing to one year; and (14) a provision that the same rules for mailing, delivery and determining timeliness that apply to requests for CDP hearings apply to requests for equivalent hearings.

Cases. In Carlson v. United States,[35] the district court held that the Appeals officer in a CDP case did not abuse her discretion in refusing to grant the taxpayer an additional 30 days to provide information, including signed tax returns for years for which returns had not been filed, in order to consider collection alternatives. The IRS will not consider an offer in compromise where the taxpayer has not filed all required tax returns. In Johnson Home Care Services Inc. v. United States,[36] the district court held that the Appeals officer did not abuse his discretion in a CDP case by rejecting the installment agreement proposed by the taxpayer because the Appeals officer reviewed the taxpayer's history of tax non-compliance, financial information, and level of indebtedness, in determining that the taxpayer was a bad risk for an installment payment plan. In Render v. IRS,[37] the district court held (i) that it did not have jurisdiction to review the taxpayer's liability for responsible person penalties under section 6672 in a CDP case, since the taxpayer previously had an opportunity to dispute her liability and failed to do so; and (ii) that the Appeals officer did not abuse his discretion in failing to consider an alternative payment plan, where the taxpayer did not submit requested documentation and the Appeals officer rejected the taxpayer's offer on the basis that she had the means to pay a greater amount.

Miscellaneous

Interest on Credit Elect Amounts. In Fleetboston Financial Corp. v. United States,[38] the Federal Claims Court held that the taxpayer was not entitled to interest with respect to overpayments (the "credit elect" amounts) for the years 1984 and 1985, because it elected, pursuant to section 6402(b), to apply those overpayments to its tax liability or estimated tax liability for succeeding years. This "credit elect" issue arose because, on audit, the IRS determined tax deficiencies against the taxpayer for 1984 and 1985, although those deficiencies ultimately were offset by operating loss carrybacks from 1987 and 1990. In computing the underpayment interest for 1984 and 1985, the IRS treated the credit elect amounts for 1984 and 1985 as payments for 1984 and 1985 only until they were credited against the tax liability for the succeeding year, *i.e.*, until March 14, 1986 and March 15, 1987, respectively.[39] The court held that pursuant to Treas. Reg. § 301.6402-3(a)(5), no interest is allowed on an overpayment that is credited against a taxpayer's tax liability for the succeeding year. The court expressly rejected the argument that the taxpayer should be allowed interest on the credit elect amounts under the "use of money" principle.

Ex Parte Communications with Appeals. In Drake v. Commissioner,[40] the Tax Court remanded the case to the IRS Appeals Office for a new CDP hearing because a memorandum provided by the IRS Insolvency Unit Advisor (the "Advisor") to the IRS Appeals Officer constituted a prohibited *ex parte* communication under Rev. Proc. 2000-43.[41] The memorandum stated that proceeds from the prior sale of three properties subject to the federal tax lien had been distributed to the taxpayers; that such proceeds should have been distributed to the taxpayers' creditors; and that the Advisor believed that the taxpayers' attorney had used the bankruptcy court to bypass the federal tax lien. The Appeals Officer did not inform the taxpayers or their representative of the memorandum or its contents. The Tax Court noted that the revenue procedure prohibits ex parte discussions of the "originating functions perception of the demeanor or creditability of the taxpayer or the taxpayer's representative . . .." The Tax Court found that the memorandum was not ministerial, administrative, or procedural in nature, and that it potentially damaged the petitioner's credibility. Therefore, the Tax Court held that the IRS Appeals Officer abused his discretion in the CDP hearing and remanded the case for a new hearing with an independent Appeals Officer not tainted by the memorandum.

Privileges - Crime-Fraud Exception. In United States v. BDO Seidman, LLP,[42] the district court denied the intervenors' motion for relief from the court's prior ruling that the intervenors had failed to rebut the government's *prima*

facie showing that the crime-fraud exception to attorney-client privilege, tax practitioner privilege and work product doctrine applied to one of 267 documents. The intervenors apparently argued that the court should reconsider its prior decision because of the Second Circuit's decision in Denney v. BDO Seidman, LLP,[43] reversing Denney v. Jenkens & Gilchrest.[44] The district court responded that it relied on Supreme Court and Seventh Circuit authorities regarding the standard for application of the crime-fraud exception, and that it did not rely on Denney v. Jenkens & Gilchrest as controlling law.

Invalid Assessment. In Snyder v. IRS,[45] the district court held that the IRS improperly assessed the taxpayer's tax as a "mathematical or clerical error" without first issuing a notice of deficiency, so both the assessment and the lien were invalid. While the failure to attach a schedule to a return is a "mathematical or clerical error" that allows the IRS to assess tax without issuing a notice of deficiency under section 6213(g)(2), the bankruptcy court found that the taxpayers had filed Schedule A with their original return, but the IRS had misplaced it. The district court held that this finding was not clearly erroneous. The bankruptcy court also found (and the IRS conceded) that the taxpayers filed the Schedule A prior to the assessment. Therefore, the IRS improperly assessed the tax without first issuing a notice of deficiency and, as a result, both the assessment and the lien were invalid.

Litigation Costs/Responsible Person. In Moulton v. United States,[46] the First Circuit held that the district court did not abuse its discretion in denying litigation costs to plaintiffs under section 7430, even though the plaintiffs were found to be responsible persons for only one of four quarters for which they were assessed under section 6672. The court found that the Government's position was "substantially justified," emphasizing that once the IRS assessed the section 6672 penalty, the plaintiffs had the burden of proving they were not responsible persons or that their failure to insure payment of the taxes was not "willful." The plaintiffs argued that they could not be responsible persons because they did not have signature authority over the corporation's operating account and that, as a matter of law, they could be responsible persons only if they actually exercised authority to pay creditors. The First Circuit stated that this argument rested on a misreading of its decisions in Vinick v. Comm'r,[47] and Vinick v. United States,[48] which held that the issue is whether, taking into account a number of factors, a person possessed sufficient control over corporate affairs to avoid the failure to pay tax. Thus, no single factor was controlling and it was a "close case" whether the plaintiffs were responsible persons for the other quarters for which the section 6672 penalty was assessed.

Sovereign Immunity. In Bacigalupo v. United States,[49] the district court held that the IRS did not waive sovereign immunity by filing a claim for unpaid federal income taxes in the probate court, after expiration of the period for filing such claims imposed by Tenn. Code Ann. § 30-2-307. To avoid the established rule that the federal government is not bound by state statute of limitations in enforcing its rights, the taxpayer argued that Tenn. Code Ann. § 30-2-307 is not a statute of limitations on claims, but is a "non-claim statute," which provides that the probate court does not have jurisdiction of an untimely claim. The court held that it is immaterial whether the Tennessee statute is a "non-claim" statute or a statute of limitations, and that there was no evidence that the IRS intended to waive its governmental immunity by filing its claim with the probate court.

Enforcement of IRS Lien Against Nominee. In Spotts v. United States,[50] the Sixth Circuit reversed and remanded the district court's determination that the taxpayer held legal title to a house as nominee for her ex-husband, because it did not consider Kentucky law in making that determination. Peggy and Ray Spotts participated in an "offshore asset protection program" in which Ray had funds transferred to an offshore bank account that he accessed using a debit card issued by an offshore bank. The Spotts purchased a home using funds provided by Peggy, and funds from the offshore bank account that were disguised as a loan from an offshore bank. The house was titled in Peggy's name. The IRS assessed tax against Ray and filed a nominee tax lien against the house. Peggy filed an action to clear title to the house. On summary judgment, the district court held that Peggy's ownership of the house was a sham designed to insulate assets from the reach of Ray's creditors. The Sixth Circuit reversed stating that, under Kentucky law, legal title raises a presumption of true ownership and where a husband puts title to property in the name of his wife, there is a presumption of a gift to the wife, so the Government has the burden of establishing that Ray did not intend to make a gift to Peggy. By deposition, Ray testified that he titled the house in Peggy's name to make Peggy feel more secure in the marriage and to insulate his business assets from creditors. Viewing the evidence in a light most favorable to Peggy, the Sixth Circuit stated that a material fact existed regarding whether Peggy was the true owner of the house, so summary judgment for the Government was not proper.

IRS Policies and Positions

Requests for Tax Accrual Workpapers. On July 28, 2005, the IRS issued Tax Accrual Workpapers Frequently Asked Questions (FAQ) describing answers to questions regarding application of the IRS policy for requesting tax accrual workpapers. In 2002, the IRS announced that it was modifying its historical policy of restraint with respect to requests for tax accrual workpapers in certain circumstances where the taxpayer had engaged in listed transactions, including transactions substantially similar to a listed transaction (LT).[51] The FAQ state, among other things, that (1) a taxpayer should be given an opportunity to explain why it believes that the transaction is not a LT; (2) that the filing of a "protective" disclosure of a LT is treated as the filing of a regular disclosure; (3) that where a transaction provides tax benefits for more than one year, strong consideration should be give to requesting tax accrual workpapers for the year the transaction was entered into regardless of the year under examination; (4) that a transaction that becomes a LT after the year the taxpayer entered into the transaction is treated as a LT; (5) that multiple investments in the same type of LT are considered multiple LTs for purposes of applying the tax accrual workpaper policy; (6) that the IRS may request tax accrual workpapers for any related year (even if not under examination) if those workpapers are relevant to the IRS audit of a known LT for the year under examination; (7) the relationships between closing agreements and requests for tax accrual workpapers in various circumstances; (8) that the IRS will request tax accrual workpapers from a taxpayer that claims benefits of a LT by filing a claim for refund or amended return; (9) a description of what constitutes proper disclosure of a LT in various circumstances; and (10) a general description of when "unusual" circumstances exist for requesting tax accrual workpapers under the IRS historical policy. *Comment:* The conclusion that the IRS will request tax accrual workpapers from a taxpayer that claims benefits of a LT by filing a claim for refund or amended return represents a change from prior IRS policy.

Disclosure of Third Party Tax Information under Section 6103. A Chief Counsel Notice (CCN) dated October 25, 2005,[52] provides guidance regarding disclosure of confidential third party taxpayer information in connection with the audits of tax shelter promoters and tax shelter investors. Section 6103(a) provides that tax returns and tax return information may not be disclosed, except as authorized by the Code. Section 6103(h)(4)(B) permits disclosure of third party returns and return information in judicial or administrative proceedings pertaining to tax administration, "if the treatment of an item reflected on such [third party's] return is directly related to the resolution of an issue in the proceeding." (This is referred to as the "item test.") Section 6103(h)(4)(C) permits disclosure of third party returns and return information in judicial or administrative proceedings pertaining to tax administration, if the third party taxpayer's tax information "directly relates to a transactional relationship between a person who is a party to the proceeding and the [third party] taxpayer which directly affects the resolution of an issue in the proceeding." (This is referred to as the "transaction test.")

The CCN concludes that information obtained upon the examination of third party tax shelter investors can be disclosed in another investor's proceeding under the "item test," if it constitutes "pattern evidence" relevant to the issue of whether any of the investors realistically could have a bona fide business or investment purpose. Such "pattern evidence" could include promotional material the third party received from a common promoter, the third party's responses to IDRs inquiring about the third party's non-tax purpose for investing in a substantially similar transaction, or the third party's tax returns reporting the same or similar transaction as the taxpayer. Thus, in a judicial proceeding as to Investor A, the IRS may disclose tax information obtained during the examination of Investors B, C, D, E and F regarding their reporting of the tax shelter loss, even though the Investors did not have a transactional relationship with each other. The CCN also concludes that information obtained upon the examination of a tax shelter investor can be disclosed in a judicial proceeding involving the tax shelter promoter (and *vice versa*) under the "transaction test."

The CCN cautions that Counsel attorneys should strike a fair and reasonable balance between the need to use third party tax information and the degree of intrusion on the third party's privacy, and that they should consider methods of proof that do not require disclosure of third party tax information such as summaries or compilations. Comment: Tax shelter investors who have settled their cases with the IRS, in part, to avoid public disclosure of their participation in a LT likely will be surprised to learn that their tax return and return information, including their responses to IDRs, may be disclosed in another tax shelter investor's tax case under the IRS interpretation of the "item test."

6-Year Limitations Period. Chief Counsel Advice (CCA) 200537029, dated June 1, 2005, addresses (1) the definition of gross income to apply the 6-year limitations period under section 6501(e) that is triggered by an omission of more than 25% of the taxpayer's gross income;53 and (2) the standard for determining whether a taxpayer may avoid the 6-year limitations period by disclosing the omitted item in a return (or in a statement attached to the return) in a manner that adequately apprises the IRS of the nature and the amount of the item.

According to the CCA, the taxpayer properly reported the gross sales proceeds from the sale of oil and gas property used in its trade or business, but understated its net sales proceeds because it used an inflated basis to determine its gain. Therefore, if gross income for purposes of section 6501(e) is gross receipts, there is no omission; and if gross income for purposes of section 6501(e) is gross sales proceeds reduced by basis, the taxpayer made a substantial omission. The CCA recognized that gross income for purposes of section 6501(e) is defined by section 61, except as provided by section 6501(e)(1)(A)(i) which states that gross receipts is gross income in the case of a trade or business selling goods or services. The CCA states that, by contrast, section 61 reflects the general principal that gross income takes into account the cost of the item sold. For example, Treas. Reg. § 1.61-3(a) provides that "in a manufacturing, merchandizing, or mining business, 'gross income' means the total sales, less the cost of goods sold." Similarly, section 61(a)(3) concerns "gains derived from dealings in property," and Treas. Reg. § 1.61-6(a) provides that, for this purpose, gain is the excess of the amount realized over the unrecovered cost or other basis for the property sold or exchanged. Therefore, the CCA asserts that section 6501(e)(1)(A)(i) applies only to a trade or business that sells a "good or service" and has no effect on the determination of gross income from dealings in property in a nonbusiness setting, *i.e.*, a casual sale of a capital asset.

The CCA argues that Colony, Inc. v. Comm'r[54] does not hold that an omission of gross income cannot result from an overstated basis for purposes of section 6501(e) in the case of a casual sale of a capital asset, since that case involved a sale of "goods" because the taxpayer's business was the development and sale of lots. The CCA concludes that Colony does not provide authority for treating gross receipts as gross income from the sale of land or other property that is not "goods." *Comment:* While not directly stated, the CCA appears to take the position that, for purposes of determining if there has been a substantial omission of gross income under section 6501(e), gross income is reduced by basis in the case of sales of property not held for sale in the ordinary course of business. Therefore, the CCA appears to conclude that the taxpayer omitted gross income when it reduced its gross sales proceeds by an inflated basis to determine gain on the sale of oil and gas properties.

In addressing the standard for determining whether a taxpayer may avoid the 6-year limitations period by disclosure, the CCA states that CC&F Western Operations LP v. Comm'r[55] represents the best statement of the IRS current view of the law. That is, the return must give a revenue agent a reason to investigate further regarding the omitted income; it is not enough that a taxpayer may string together a series of inferences that could have lead to the discovery. By contrast, the CCA rejects the argument that a disclosure is sufficient if "respondent has been furnished with a 'clue' as to the existence of the error." While the origin of the "clue test" is the Supreme Court's decision in Colony, the CCA states that taxpayers are taking the test out of context by failing to recognize the Supreme Court's entire description of the nature of the disclosure required under section 6501(e)(1)(A)(ii) to avoid the 6-year limitations period.

ENDNOTES

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2 67 Fed. Cl. 657 (2005).

3 Section 6229(a) provides: "Except as otherwise provided in this section, the period for assessing any tax imposed by subtitle A with respect to any person which is attributable to any partnership item (or affected item) for a partnership taxable year shall not expire before the date which is 3 years after the later of -
 (1) the date on which the partnership return for such taxable year was filed, or
 (2) the last day for filing such return for such year (determined without regard to extensions)."
4 114 T.C. 533, 542 (2000), appeal *dism'd* and *remanded*, 249 F.3d 175 (3rd Cir. 2001).
5 331 F.3d 972, 976 (D.C. Cir. 2003), *aff'g* 83 T.C.M. (CCH) 1476 (2002).
6 AD Global Fund, LLC ex rel North Hills Holding, Inc. v. U.S., 96 A.F.T.R. 2d 2005-7011 (Fed. Cl. 2005).
7 67 Fed. Cl. 708 (2005).
8 783 F.2d 190 (Fed. Cir. 1986).
9 429 F.3d 533 (5th Cir. 2005), *vacating*, 123 T.C. 15 (2004).
10 Section 7481(c)(1) and (2)(B) provide that within 1 year after a Tax Court decision reflecting an overpayment becomes final, the taxpayer may file a motion for redetermination of interest, and the Tax Court may reopen the case solely for the purpose of determining overpayment and underpayment interest. Section 7481(c)(3) further provides that the Tax Court's decision regarding interest under section 7481(c) is treated under section 6512(b)(1) as a determination of an overpayment of tax and is reviewable in the same manner as a decision of the Tax Court.
11 Section 6512(b) gives the Tax Court jurisdiction to determine an overpayment of tax and to order a refund of such overpayment and interest, if it has jurisdiction over a deficiency for the same tax and transaction.
12 125 T.C. No. 5 (2005).
13 118 T.C. 22 (2002).
14 425 F.3d 1203 (9th Cir. 2005), *aff'g* 121 T.C. 89 (2005), supplemented, 87 T.C.M. (CCH) 998 (2004).
15 125 T.C. No. 7 (2005).
16 119 T.C. 356 (2002).
17 420 F.3d 589 (6th Cir. 2005).
18 Section 1346(a)(1) provides: "The district courts shall have original jurisdiction, concurrent with the United States Court of Federal Claims, of . . . [a]ny action against the United States for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed or collected, or any penalty claimed to have been collected without authority or any sum alleged to have been excessive or in any manner wrongfully collected under the internal-revenue laws[.]"
19 *Citing* Amoco Production Co. v. United States, 61 A.F.T.R. 2d 88-750 (N.D. Ill. 1988).
20 391 F. Supp. 2d 122 (D.D.C. 2005).
21 Tax Analysts v. IRS, 294 F.3d 71 (D.C. Cir. 2002).
22 CCA are documents prepared by National Office Chief Counsel attorneys in response to requests for guidance on legal interpretations and IRS policy with respect to tax law.
23 Subject to many exceptions, section 6103 prohibits the IRS from disclosing tax returns and tax return information.
24 151 Fed. Appx. 941 (Fed. Cir. 2005) (not selected for publication in the Federal Reporter), *aff'g* 64 Fed. Cl. 557 (2005).
25 96 A.F.T.R. 2d 2005-6471 (D. N.J. 2005).
26 487 U.S. 99 (1988).
27 530 U.S. 27, 38 (2000).
28 125 S. Ct. 1270 (2005).
29 429 F.3d 1026 (11th Cir. 2005).
30 96 A.F.T.R. 2d 2005-7172 (5th Cir. 2005).
31 The Office of Chief Counsel expects petitioners to file motions to vacate or motions for a new trial in these cases on the basis that there was a denial of due process or that other defects existed in the manner in which the case was decided. *See* Notice CC-2005-017 (2005).
32 BNA Daily Tax Report, No. 182 (2005).
33 REG-150088-02 and REG.-150091-02.
34 This would mean that prior participation in a CDP hearing would not constitute prior involvement.
35 394 F. Supp. 2d 321 (D. Mass. 2005).
36 96 A.F.T.R. 2d 2005-6085 (E.D. N.Y. 2005).
37 389 F. Supp. 2d 808 (E.D. Mich. 2005).
38 68 Fed. Cl. 177 (2005).
39 The IRS allowed interest on the credit elect amount commencing when the 1984 and 1985 deficiencies were offset by loss carrybacks from 1987 and 1990.
40 125 T.C. No. 9 (2005).
41 2000-2 C.B. 404.
42 96 A.F.T.R. 2d 2005-6318 (N.D. Ill. 2005).
43 412 F.3d 58 (2d Cir. 2005).
44 340 F. Supp. 2d 338 (S.D. N.Y. 2004). The Second Circuit reversed the district court's finding of mutual fraud in a consulting agreement between BDO Seidman and its clients and, further, declared the arbitration clause in that agreement to be enforceable, remanding the case for consideration whether a non-party, Deutsche Bank, could compel arbitration under the agreement.
45 96 A.F.T.R. 2d 2005-6607 (D. Md. 2005).
46 429 F.3d 352 (1st Cir. 2005).
47 110 F.3d 168 (1st Cir. 1997).
48 205 F.3d 1 (1st Cir. 2000).
49 399 F. Supp. 2d 835 (M.D. Tenn. 2005).
50 429 F.3d 248 (6th Cir. 2005).
51 Ann. 2002-63, 2002-27 IRB 72.
52 CC-2006-003.
53 The CCA notes that since a partnership is involved, the applicable limitations provision is section 6229(c)(2); but the CCA will look to the law developed under section 6501(e) to apply the TEFRA partnership provisions. See discussion of AD Global Fund LLC v. United States above on the relationship between section 6229 and section 6501.
54 357 U.S. 28 (1958).
55 273 F.3d 402 (1st Cir. 2001).

CORPORATE TAXATION: RECENT DEVELOPMENTS

Samira A. Salman and Glenn T. Leishner[1]

The following is a summary of selected current developments in corporate tax law. Unless otherwise indicated, all Section references are to the Internal Revenue Code of 1986, as amended ("the Code"). The Internal Revenue Service is referred to as the Service.

Proposed Regulations to Treat Disregarded Entities as Separate for Employment and Excise Taxes

On October 18, 2005, the Service issued proposed REG-114371-05.[2] The regulations would treat qualified subchapter S subsidiaries ("QSubs") and single-owner eligible entities (currently disregarded as entities separate from their owners for federal tax purposes or "disregarded entities") as separate entities for employment tax and related reporting purposes and for reporting, paying, and taking other actions related to certain federal excise taxes.

Background

QSubs under Section 1361(b)(3)(B) and certain single-owner eligible entities under Treas. Reg. §§ 301.7701-1 through 301.7701-3 are disregarded entities. The disregarded entity rules apply for all purposes of the Code, including employment and excise taxes.

Administrative difficulties have arisen from the interaction of the disregarded entity rules and the federal employment tax provisions. The difficulties have affected both taxpayers and the Service with respect to the reporting, paying and collecting of employment taxes. Problems have arisen when

state employment tax law sets requirements for reporting, paying and collecting state employment taxes that may be in conflict with the federal disregarded entity rules. Difficulties have also arisen from the interaction of the disregarded entity rules and certain federal excise tax provisions. Again, where the federal provisions rely on state law to determine liability for an excise tax, attachment of a tax, and allowance of a credit, refund or payment, the state law determination might not be aligned with the federal disregarded entity rules.

Proposed Regulations

The proposed regulations would eliminate disregarded entity status for purposes of federal employment taxes and certain excise taxes.

Under the proposed regulations, an otherwise disregarded entity would be considered regarded for employment tax purposes, and, accordingly, become liable for employment taxes on wages paid to employees of the disregarded entity. A disregarded entity would also be responsible for satisfying other employment tax obligations (e.g., backup withholding under Section 3406, making timely deposits of employment taxes, filing returns, and providing wage statements to employees on Forms W-2). The owner of the disregarded entity would no longer be liable for employment taxes or satisfying other employment tax obligations with respect to the employees of the disregarded entity. The entity would continue to be disregarded for other federal tax purposes. The employment tax provisions of these regulations are proposed to apply to wages paid on or after January 1 following the date the regulations are published as final. All disregarded entities can continue to use the procedures permitted by Notice 99-6[3] to satisfy the owners' employment tax liabilities and other employment tax obligations for periods before the effective date of the regulations.

Also under the proposed regulations, an entity that is disregarded for federal tax purposes would be required to pay and report excise taxes, required and allowed to register, and allowed to claim any credits (other than income tax credits), refunds, and payments. The excise tax provisions include chapters 31, 32, 33, 34, 35, 36, and 38 of the Code but chapters 32 and 36 are specifically excluded. The excise tax provisions are proposed to apply to liabilities imposed and actions first required or permitted in periods beginning on or after January 1 following the date the regulations are published as final in the Federal Register. For periods before the effective date, the owner of a disregarded entity will be treated as satisfying the owner's obligations with respect to the excise taxes affected by these regulations, provided that those obligations are satisfied either (i) by the owner itself or (ii) by the disregarded entity on behalf of the owner.

Comment Period

The Service and Treasury Department request comments on the clarity of the proposed regulations and how they may be made easier to understand. Additionally, comments are requested specifically on any transition issues that might arise with respect to employment taxes, and any transition relief that should be provided.

Guidance on How to Make a Stock Basis Reduction Election

On October 11, 2005, the Service issued Notice 2005-70[4] to provide guidance regarding how a valid election under Section 362(e)(2)(C) can be made pending the issuance of additional guidance.

Background

Section 362(e) was enacted on October 22, 2004, as part of the American Jobs Creation Act of 2004 to limit the transfer or importation of built-in losses. The provision prevents the economic loss inherent in transferred assets from being replicated both in the transferor's basis in the stock and the basis of the assets in the hand of the corporate transferee.

Under Section 362(a), a corporation's basis in assets received in a tax-free transfer is the same as the adjusted basis of the assets in the hands of the transferor, increased by the amount of any gain recognized by the transferor in the transaction. The basis of the transferred assets is also replicated in the basis of the stock received by the transferor in the exchange, adjusted for any gain or loss recognized by the transferor, and for the amount of any money or property received in the exchange.[5]

According to the Notice, these basis rules allowed for tax avoidance potential when the transferee is a foreign person or in a domestic 351 transaction. When the transferee is a foreign person, there is a tax avoidance potential where assets with foreign-generated built-in losses are imported into the U.S. and used to shelter U.S. income that would otherwise be taxed. Before the addition of Section 362(e) the rules only dealt with the expatriation of built-in gain property intended to shelter the inherent gain from U.S. taxation,[6] but they did not address the importation of built-in losses into the U.S. Additionally, since the Section 362 basis rules apply to Section 351, those transfers could also result in the duplication of built-in losses.

Addition of Section 362(e)

Section 362(e)(2)(A) generally provides that, if property is transferred to a corporation as a capital contribution or in a Section 351 exchange, and the aggregate basis of the transferred property exceeds its aggregate value immediately after the transaction, then the transferee corporation's basis in such property shall not exceed the fair market value of that property.

Section 362(e)(2)(C) allows the transferor and the transferee to make a joint election to reduce the transferor's basis in the stock to its FMV (therefore eliminating the need to reduce the transferee's basis in the property received).

Section 362(e)(2)(C)(ii) provides that the election to reduce stock basis shall be filed with the tax return for the taxable year in which the transaction occurred, shall be in the form and manner prescribed by the Secretary, and shall be irrevocable.

Additional Guidance

The Notice states the Service and Treasury Department are studying the issues raised by Section 362(e), including the way to make the Section 362(e)(2)(C) election. Specifically, the Service and Treasury Department are considering issuing guidance prescribing a particular form and manner for making the election. In the interim, the Service will treat elections as effective under Section 362(e)(2)(C) if they are made in the form and manner set forth in the Notice or if the statements disclose sufficient information to apprise the Service that an election has been made.

Guidance on Section 355(e) "Plan" Requirement

On October 11, 2005, the Service released Revenue Ruling 2005-65,[7] which addresses whether a pre-distribution acquisition of 55 percent of Distributing's outstanding stock is

part of a plan that includes the distribution of Controlled within the meaning of Section 355(e).

Background
The management of Distributing determined that the separation of Distributing's business from the business of its subsidiary, Controlled, would eliminate the competition for capital between the two businesses. Distributing made a public announcement that the distribution would occur.

After the public announcement but before the distribution X, a corporation engaged in the same business as Distributing, began discussions with Distributing regarding an acquisition. The negotiations included discussions of the distribution of Controlled, which X favored. Ultimately, the negotiations resulted in the merger of X with and into Distributing, in which the former X shareholders received 55 percent of Distributing's stock. Following the merger, X's former chairman and CEO replaced the chairman and CEO of Distributing, and the distribution of Controlled proceeds for the same "capital competition" business reasons. Nothing in the merger agreement required the distribution.

Analysis
In general, Section 355(c) provides that no gain or loss is recognized to the distributing corporation on a distribution of stock in a controlled corporation to which Section 355 applies and that is not in pursuance of a plan of reorganization. Section 355(e) denies the non-recognition treatment of Section 355(c) if the distribution is part of a plan (or a series of related transactions) pursuant to which one or more persons acquire directly or indirectly stock representing a 50 percent or greater interest in the distributing corporation or any controlled corporation.

The Treasury Regulations under Section 355 provide that whether a distribution and an acquisition are part of a plan is determined based on all the facts and circumstances,[8] including a non-exclusive list of applicable "plan" and "non-plan" factors.[9] Additionally, Treas. Reg. § 1.355-7 provides certain safe harbors under which an acquisition and distribution are presumed not to be part of a plan. Safe Harbor V (which appears to apply to the transaction described in the Ruling) is inapplicable because X shareholders own 55 percent of the outstanding Distributing stock immediately after the merger.

Failure to satisfy a safe harbor means the parties must apply a facts and circumstances test to determine whether the acquisition and distribution are part of a plan. The Service evaluated the transaction in light of the plan and non-plan factors provided in the Treasury regulations. The weight given to each of the facts and circumstances depends on the particular case. The determination does not depend on the relative number of plan factors compared to the number of non-plan factors that are present.

The Service found the acquisition and distribution were not part of a plan under Section 355(e) and Treas. Reg. § 1.355-7(b). The Service reached this finding by considering all the facts and circumstances and specifically focused on two facts: (a) the distribution was motivated by a corporate business purpose (within the meaning of §1.355-2(b)) other than a business purpose to facilitate the acquisition or a similar acquisition; and (b) the distribution would have occurred at approximately the same time and in similar form regardless of the acquisition or a similar acquisition.

Final Regulations for Measuring When to Determine the Section 368 "Continuity of Interest" Requirement

In addition to complying with statutory and certain other requirements to qualify as a reorganization, a transaction generally must satisfy the continuity of interest ("COI") requirement. On September 16, 2005, the Treasury Department and Service issued final regulations under Section 368 that address the point in time for measuring whether a transaction satisfies the COI requirement for a Section 368 reorganization.[10] Generally, COI requires that a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization.

The time for such testing can be critical if the value of the issuing corporation stock declines relative to the other consideration issued to the target shareholders between the date the parties agree to the terms of the deal (the "signing date") and the date the transaction closes (the "closing date") so that the fair market value of the issuing corporation stock constitutes less than the requisite percentage of the value of the total consideration received by the target shareholders.

In determining whether a transaction satisfies the COI requirement, the initial proposed regulations looked to the value of the consideration to be exchanged for the proprietary interest in the target corporation on the signing date provided that certain requirements were satisfied. Specifically, the proposed regulations looked to the value of this consideration as of the end of the last business day before the first date there was a binding contract to effect the potential reorganization, if the consideration to be provided to the target corporation shareholders (1) was fixed in the binding contract and (2) included only money and the issuing corporation stock.

The final regulations adopt the general framework of the proposed regulations issued on August 10, 2004, but made several modifications favorable to taxpayers in response to comments.

Binding Contract Requirement
The signing date is used only if the parties sign a binding contract to effect the reorganization. A binding contract is an instrument that is enforceable under applicable law against the parties to the instrument. A tender offer subject to Section 14(d) of the Securities and Exchange Act of 1934 and regulation 14D is treated as a binding contract, even though the tender offer is not made pursuant to a binding contract. Also, the existence of a condition outside the control of the parties to a contract (e.g., regulatory agency or shareholder approval) will not prevent the contract from being binding. If the contract or tender offer is modified before the closing date concerning the amount or type of consideration the target corporation shareholders may receive, then the modification date is treated as the first date there is a binding contract.[11]

Fixed Consideration
The signing date is used only if the consideration is fixed in the binding contract. The consideration is treated as fixed if the contract states the exact number of shares of the issuing corporation and the exact amount of money, if any, to be exchanged for the proprietary interests in the target corporation.

Variable consideration, however, will be treated as fixed consideration if (1) a target corporation shareholder has an election to receive issuing corporation stock and/or money concerning target stock and (2) the minimum amount of the

issuing corporation stock and the maximum amount of the money that the target shareholders might receive can be determined. In such a situation, these minimum and maximum amounts will be used to determine whether the COI requirement is satisfied, regardless of the actual number of shares and amount of money later exchanged. Placing part of the issuing corporation stock or money paid in escrow to secure customary target corporation representations does not prevent the consideration from being fixed.[12]

The final regulations expand the circumstances in which a contract will be treated as providing for fixed consideration. For example, under the final regulations a contract is treated as satisfying the fixed consideration requirement if it provides for either the percentage of (a) the number of shares of each class of stock or (b) the value of the shares, to be exchanged for stock of the issuing corporation. This treatment results provided the shares of the target corporation to be exchanged for stock and other consideration, represents an economically reasonable exchange. The final regulations also provide for a limited exception to the general rule that an arrangement that provides for contingent consideration will not be one to which the signing date rule applies. In general, the exception applies to cases in which the contingent consideration consists solely of stock of the issuing corporation.[13]

Valuation

The final regulations remove the requirement that the consideration be valued as of the end of the last business day before the first date there is a binding contract. Instead, they provide general guidance that the consideration to be exchanged for stock of the target corporation pursuant to a contract must be valued the day before such contract is binding.[14] This change provides flexibility in valuation methodology. For example, the stock may be valued based on the average high and low trading prices for that day. The final regulations also clarify that if the issuing corporation issues a new class of stock in the reorganization, the new class of stock is deemed to have been issued on the last business day before the first date there is a binding contract for purposes of applying the signing date rule.[15]

Satisfaction of the Requirement for Advance Ruling Purposes

For advance ruling purposes, Rev. Proc. 77-37[16] contains guidance on satisfaction of the COI requirement. The guidance states that the COI requirement is satisfied if the acquiring corporation acquires at least 50 percent of the value of the target corporation.

It is interesting to note that in Explanation section H of the Treasury Decision, the Service addressed a commentator's question by stating that the COI requirement is satisfied where 40 percent of the target corporation stock is exchanged for issuing corporation stock.[17] This view is in line with the Supreme Court's findings in Nelson that at least 38 percent of target corporation stock must be exchanged for issuing corporation stock.[18] The discussion in the Treasury Decision may indicate that the Service will lower the percentage required for advance ruling purposes. Confirmation of this new position would appear in a new revenue procedure.

Tax Court Rejects Tax-Free Reorganization; Instead Finds a $1.375 Billion Sale

On September 27, 2005 (amended October 13, 2005), the Tax Court held that a legal publisher's reorganization failed to qualify as either (1) a tax-free B reorganization, because the exchange was not solely for stock, or (2) as a tax-free reverse triangular merger, because the control test was not satisfied.[19] A newspaper publisher, Times Mirror ("Times"), through a series of transactions, transferred its interest in its subsidiary Matthew Bender & Co. Inc. ("Bender") to Reed Elsevier ("Reed") as part of a purported tax-free reorganization. Times chose a corporate joint venture structure as a tax-efficient framework for the divestiture, which would result in no tax due on the sale of Bender. After Times reached an agreement with Reed on the sale of Bender for $1.375 billion, the two companies executed the transaction, which was structured as a reorganization on July 31, 1998. In the transaction, a special purpose entity was created and owned by Reed and Times. Reed controlled the entity, which owned an acquisition subsidiary and an interest in a limited liability company ("LLC"). The acquisition subsidiary merged with Bender. Times controlled the LLC, which held cash. After the transaction, Times had total control over the assets and operations of the LLC and Reed had total control over the assets and operation of Bender.

The court concluded that the series of transactions was, in substance, a sale of Times's Bender subsidiary for $ 1.375 billion. In reaching that conclusion, the court noted that the various contractual documents and other evidence of the parties' understanding showed that Times had control over LLC's cash. The parties understood that by issuing common stock to the Times subsidiary that owned Bender and only preferred stock to Reed Subs, any fiduciary duty to Reed Subs was eliminated. As such, Times had effective control over the cash in the LLC. On the basis of that factual finding, the court determined that the transaction failed to meet the solely-for-stock requirement of Section 368(a)(1)(B).

The court also considered whether Times acquired at least 80 percent of the value of the acquisition subsidiary stock to qualify as a reverse triangular merger. The court stated that the structure and the legal rights of the parties to vote, receive dividends, redeem, and liquidate confirm that Times "had a continuing economic interest in the cash, and only Reed had a continuing economic interest in Bender."[20] The value Times received was control over the cash in the LLC; as a separate property right, the common stock in acquisition subsidiary had no value. The court determined that the common stock's value was less than 80 percent of the total value. Accordingly, Times did not acquire enough value in acquisition subsidiary to satisfy the control test in section 368(c).

Treasury, Service Provide Retroactive Guidance on the Effect of Certain Asset Reorganizations on Section 367(a) Gain Recognition Agreements

On October 17, 2005, the Service released Notice 2005-74,[21] stating that the treasury regulations under Section 367(a) will be amended regarding the application of Treas. Reg. § 1.367(a)-8, including the provisions that address the treatment of Gain Recognition Agreements ("GRA") as a result of certain common asset reorganizations.

Background

As a general rule, Section 367(a) denies nonrecognition treatment in certain otherwise tax-free transactions[22] if a U.S. person transfers property to a foreign corporation. Treas. Reg. §1.367(a)-3 provides exceptions to the general rule and allows the U.S. transferor to enter into a GRA. The GRA requires the U.S. transferor to include in income any gain realized but not recognized on the initial transfer of the stock or securities (plus interest), if certain triggering events occur within five years following the year of transfer.[23]

Triggering events include dispositions of the stock or securities or substantially all the assets of the transferred

corporation, and dispositions of stock of the transferee foreign corporation.[24] Notwithstanding these rules, some nonrecognition transactions are not triggering events, if certain requirements are satisfied.[25]

Commentators, taxpayers, and tax advisors have stated that, although these requirements clearly contemplate certain nonrecognition transactions, it is not clear whether the exceptions apply to various asset reorganizations involving the U.S. transferor, the transferee foreign corporation, and the transferred corporation. Specifically, the language of exceptions to GRA triggers does not address exchanges in certain asset reorganizations.

Guidance Issued

In response, the Service issued Notice 2005-74 to clarify how the exceptions apply to various asset reorganizations, and stated that it will issue regulations applying the Notice. Until then, taxpayers may elect to apply the rules in the Notice retroactively to exchanges occurring on or after July 20, 1998,[26] provided that they apply the rules consistently to all transactions within the scope of the Notice for all open years.

ENDNOTES

1 Shell Oil Company, P.O. Box 2463, Houston, TX 77252-2463; samira.salman@shell.com, glenn.leishner@shell.com.
2 70 Fed. Reg. 60475 (2005).
3 1999-1 C.B. 321.
4 2005-41 I.R.B. 694.
5 I.R.C. § 358(a).
6 I.R.C. §§ 367, 897 and 1291.
7 2005-41 I.R.B. 684.
8 Treas. Reg. § 1.355-7(b)(1).
9 Treas. Reg. §§ 1.355-7(b)(3) (plan factors), 1.355-7(b)(4) (non-plan factors).
10 T.D. 9225, 70 Fed. Reg. 54631 (2005).
11 Treas. Reg. § 1.368-1(e)(2)(ii).
12 Treas. Reg. § 1.368-1(e)(2)(iii).
13 *Id.*
14 Treas. Reg. § 1.368-1(e)(2)(i).
15 Treas. Reg. § 1.368-1(e)(2)(iv).
16 1977-2 C.B. 586.
17 T.D. 9225, 70 Fed. Reg. 54631 (2005).
18 *Nelson v. Helvering*, 296 U.S. 374 (1935).
19 *Tribune Co. v. Commissioner*, 135 T.C. No. 8 (2005).
20 *Id.* at 191.
21 2005-42 I.R.B. 726.
22 Exchanges described in §§ 332, 351, 354, 356, or 361.
23 Treas. Reg. §§ 1.367(a)-8(b)(1)(iii) and (3)(i).
24 Treas. Reg. §§ 1.367(a)-8(e)(1), (2), and (3) and 1.367(a)-8(f)(2)(ii).
25 Treas. Reg. § 1.367(a)-8.
26 The effective date of the current Section 367(a) regulations.

RECENT DEVELOPMENTS APPLICABLE TO THE ENERGY AND NATURAL RESOURCES TAX AREA

Janet P. Jardin[1]

The following is a summary of selected current developments in the law relating to the energy and natural resources tax area. The summary focuses on federal tax law. It has been prepared by Janet Jardin, Vice-Chair of the Energy and Natural Resources Tax Committee and an associate at Thompson & Knight, and Katrina Welch, Chair of the Energy and Natural Resources Tax Committee and Tax Counsel at Texas Instruments,[2] with the assistance of Reagan Birt, an associate at Thompson & Knight. Unless otherwise indicated, all Section references are to the Internal Revenue Code of 1986, as amended (the Code).

A. IRS Issues Guidance on New Clean Renewable Energy Bonds.

A new category of tax credit bonds (clean renewable energy bonds) was added as part of Section 54 of the Code pursuant to the Energy Tax Incentives Act of 2005, Pub. L. No. 109-58. Section 54 generally authorizes up to $800 million of tax credit bonds to be issued by qualified issuers to finance certain renewable energy products described in Section 45(d) of the Code. Section 54 is applicable to bonds issued after December 31, 2005 and before January 1, 2008.

The tax credit bonds are allowed to be issued to qualified issuers that apply for an allocation of the $800 million allowed amount. Notice 2005-98, 2005-52 I.R.B. 1 (Dec. 12, 2005), solicits applications for allocations of the clean renewable energy bond limitation and also sets forth guidance on: (1) the requirements that must be satisfied for a project to be eligible for a part of the allocation amount; (2) the methodology Treasury will use in administering the allocation; and (3) the credit rate, maximum term, and information reporting requirements that apply. To be considered for the allocation, applications meeting the requirements of Notice 2005-98 must be filed with the IRS on or before April 26, 2006

Notice 2005-98 also announced that temporary and proposed Treasury Regulations will be issued under Section 54. The Regulations will contain certain remedial action provisions and arbitrage restrictions.

B. IRS Certifies Hybrid Vehicles for Clean-Fuel Deduction.

The IRS has announced that the 2006 Ford Escape Hybrid and the 2006 Mercury Mariner Hybrid will qualify for the clean-burning fuel deduction, which allows taxpayers who purchase such vehicles new in 2005 to claim a deduction of up to $2000 on their 2005 Form 1040. This deduction was designed to mitigate the increased costs associated with the purchase of a vehicle that uses clean-burning fuel, thus encouraging individuals to buy such vehicles. This deduction must be taken in the year the vehicle is originally used and is available to taxpayers regardless of whether they itemize. This deduction expired on December 31, 2005 and has been replaced for future years by the Alternative Motor Vehicle Credit, pursuant to the Energy Act of 2005.

C. Continued Guidance on Common Issues Concerning Section 29 Credits.

In PLR 200541024 (Oct. 14, 2005), the IRS issued guidance on common issues, including:

- Whether a certain contract constituted a "binding written contract in effect before January 1, 1997," within the meaning of Section 29(g)(1)(A).
- Whether a certain process would produce a "qualified fuel" within the meaning of Section 29(c)(1)(C).

- Whether production for a facility will be attributed solely to a certain taxpayer within the meaning of Section 29(a)(2)(B) such that the taxpayer will be entitled to Section 29 credits for qualified fuel produced by the facility and sold to unrelated persons.

- Whether, if a facility was placed in service prior to July 1, 1998, the relocation of the facility after the date on which the facility was first placed in service, or the replacement of part of the facility after that date, would result in a new "placed in service" date for the facility for purposes of Section 29, provided the fair market value of the original property was more than 20% of the facility's total fair market value at the time of the relocation or replacement.

- Whether, if a facility was placed in service prior to July 1, 1990, certain described modifications to the processors in the facility would result in a new "placed in service" date for the facility for purposes of Section 29, provided such changes did not significantly increase the production capacity of the facility or significantly extend the life of the facility.

- Whether Section 29 credits may be allocated through indirect ownership under the principles of Section 702(a)(7).

- Whether a termination of a partnership under Section 708(b)(1)(B) will preclude the reconstituted partnership from claiming Section 29 credits on the production and sale of synthetic fuel to unrelated persons.

D. Injection Resembling Waterflooding Qualifies for Section 43 EOR Credit.

The IRS concluded in PLR 200546011 (Aug. 5, 2005) that an oil producer's injection of a certain injectant resembling waterflooding qualifies as a tertiary recovery method for purposes of the Section 43 enhanced oil recovery (EOR) credit. The facts of the ruling involved a certain field where a miscible water alternating gas (WAG) project was implemented in specific zones of a particular formation after production began to level off. The miscible WAG project was certified as an EOR project. The taxpayer intended to implement a project involving the injection of a certain injectant into the intervals of the formation instead of a conventional injectant. The intervals would be very minimally affected by the miscible WAG project.

The taxpayer represented that the proposed recovery method changes the properties of the reservoir fluids by increasing the pH of the fluids; by reducing the interfacial tension between the oil, reservoir rock, and water; and by increasing the water wettability of the reservoir. Consequently, the injection provides the energy and drive mechanism to force the oil to a production well.

The IRS noted in its analysis that the injection of the injectant resembles waterflooding, which the Section 43 Treasury Regulations explicitly disqualify from being a qualified tertiary recovery method. However, the IRS concluded that the taxpayer's method under consideration causes changes in the properties of the fluids in the reservoir that do not occur with conventional waterflooding. As further support for its conclusion, the IRS noted that the proposed recovery method is not a conventional recovery method that was in use at the time Section 43 was enacted. Based on these facts and other representations by the taxpayer, the IRS concluded that the recovery method to be implemented by the taxpayer was a qualified tertiary recovery method and, therefore, the project using the method would be a qualified tertiary recovery project provided that it met the other requirements under Section 43 and the Treasury Regulations thereunder.

E. Certain Changes in Activities of Oil and Gas Field Operator Do Not Constitute a Significant Expansion for Section 43 EOR Credit Purposes.

The IRS determined in TAM 200535028 (May 5, 2005) that the taxpayer failed to establish that it had increased its expected ultimate oil recoveries due to the recovery of oil from substantially unaffected reservoir volume and thus its activities did not constitute a significant expansion of the project for Section 43 EOR purposes. The facts at issue involved modifications to a pre-1991 recovery project implemented on a unit operated by the taxpayer. Before 1991, the taxpayer implemented a miscible CO_2 WAG tertiary recovery method on the unit. After undertaking a WAG ratio optimization and economic study, the taxpayer adjusted the pre-1991 project by increasing its target hydrocarbon pore volume (HCPV), decreasing the CO_2 and water slug sizes, varying its WAG ratio, and improving the placement of injectants by using polymer gel technology and drilling directional wells. A memorandum from one of the taxpayer's engineers stated that additional production would be attributable to post-1990 activities. The taxpayer did not drill new wells or perforate new intervals within the reservoir.

The IRS rejected what it termed the taxpayer's "snapshot" theory of significant expansion, which the IRS contends is based on the incremental oil that would remain unrecovered had the pre-1991 project been terminated on December 31, 1990. The IRS stated that the snapshot theory could not be correct as it would allow a mere continuation of the same EOR project to be considered a significant expansion. This would produce the absurd result of creating a rule for terminated projects that is considerably more harsh than for a taxpayer who uses a hypothetical termination as the basis for a significant expansion.

The IRS set forth its interpretation of the requirement that a significant expansion affect substantially unaffected reservoir volume. According to the IRS, it is "obvious that, at the least, new wells or new perforations are required." Accordingly, to demonstrate a significant expansion, a taxpayer must be able to show that it began injecting into new acreage, a new reservoir, or a new portion of the reservoir (such as a new interval or zone in the reservoir) into which it had not been injecting the tertiary injectant under the pre-existing EOR project. The IRS stated that this can be demonstrated by proof that new wells were drilled to new acreage, new reservoirs, or a new interval or zone in the reservoir; that perforations were made in new intervals of the reservoir; or that injections were made into pre-existing perforations that had never received injections before 1991.

The IRS further set forth specific guidelines for what constitutes an "adequate delineation" of the reservoir from which the ultimate recovery of crude oil is expected to be increased as a result of the implementation and operation of the significant expansion project and of the reservoir volume affected by the pre-existing EOR project. The IRS provided that "an adequate delineation of necessity requires a three dimensional depiction of the portion to be affected." The IRS noted that this is by and large done through the use of specialized diagrams (such as contour maps, cross sections,

or drawings) using perspective to highlight the reservoir in three dimensions. The IRS conceded that an adequate delineation could in theory be achieved through a detailed narrative but stated that "this is rarely, if ever, done as a matter of industry practice," hinting at its preference for diagrams.

The taxpayer in TAM 200535028, the IRS determined, did not adequately delineate that its post-1990 activities affected substantially unaffected reservoir volume as the taxpayer continued injections into the same reservoir volume and did not demonstrate that the injections went into new intervals of the reservoir (and where it did, the IRS allowed the credit and those activities were not included in this TAM). Rather, the IRS stated that the taxpayer's post-1990 activities included in this TAM were intended to improve efficiency and effectiveness of the pre-exiting project rather than reach new portions of the reservoir. The IRS concluded, therefore, that the taxpayer had not significantly expanded its pre-existing EOR project.

F. Mine Operator Must Change Method of Allocating Costs.

The IRS concluded in TAM 200545044 (Aug. 8, 2005) that a mining company taxpayer is required to capitalize under Section 263A and allocate the drilling, blasting, loading, and hauling costs related to a particular metal that it produces using a leaching process. There, the taxpayer operated an open mine pit. It produced a certain metal mainly using a concentration process and sometimes using a leaching process. The taxpayer capitalized all its drilling, blasting, loading, and hauling costs and allocated them all to the metal produced by the concentration process. The IRS determined that the metal produced by the leaching process was not scrap, as the taxpayer contended, and concluded that the costs related to such metal must be allocated to it. Finally, the IRS noted that a Section 481(a) adjustment must be made and that the taxpayer was not entitled to relief under Section 7805(b).

G. Excise Tax Changes under the Transportation Act.

The recently enacted Transportation Act of 2005 has made numerous excise tax changes. Some of these changes include:

- Delaying until October 1, 2011 the effective rate of reductions for various excise fuel tax rates that were scheduled to take effect on October 1, 2005.

- Providing that a 24.3¢ per gallon retail tax rate will apply to liquefied natural gas, any liquid fuel (other than ethanol and methanol) derived from coal (including peat), and liquid hydrocarbons derived from biomass, under the Section 29 nonconventional source fuel income tax credit. An 18.3¢ per-energy-equivalent-of-a-gallon-of-gasoline, retail tax rate will apply to compressed natural gas effective for any sale or use for any period after September 30, 2006.

- Imposing a 24.3¢ per gallon kerosene (and diesel fuel) tax rate on the entry or removal of aviation-grade kerosene, and on sales of aviation-grade kerosene to any unregistered person, unless there was a prior taxable removal or entry of the fuel.

- Requiring farmers to pay tax when they buy taxable clear diesel and claim a refund for amounts used for farming purposes, effective for sales after September 30, 2005.

- Requiring credit card companies that allow tax-exempt fuel purchases on their credit cards to register with IRS and to be responsible for claiming refunds of the tax.

Furthermore, under the Transportation Act, the IRS must report on new technologies that can be used to reduce diesel fuel tax evasion, including the use of chemical markers not later than 360 days after the enactment date.

H. International Developments.

The Russian Economic Development and Trade Ministry Proposes Legislation to Encourage the Extraction of Oil. The Russian Economic Development and Trade Ministry recently submitted proposed legislation that would modify the Russian Tax Code and encourage the extraction of oil by both reducing the natural resources extraction tax for oil fields that are at least 80% worked out and exempting new oil fields from the tax. This new law would apply as of January 1, 2007. The Ministry is also working on the differentiation of excise taxes on petroleum products, which should also be implemented in 2007.

Italy Abandons Proposed Energy Network Tax. On October 14, 2005, Italy's cabinet approved a set of measures that are designed to help the country meet its 2005 budget deficit target. One of the approved provisions replaces a proposed energy network tax with a measure that requires energy companies to amortize equipment costs over a longer period. The proposed energy network tax was removed from the draft budget bill after it generated strong opposition from energy industry executives and legislators.

ENDNOTES

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RECENT DEVELOPMENTS APPLICABLE TO TAX-EXEMPT ORGANIZATIONS

The following summary of selected recent developments in the law applicable to tax-exempt organizations was prepared by Tyree Collier for the Exempt Organizations Committee of the Section of Taxation.[1] Unless otherwise indicated, all section references contained herein are references to the Internal Revenue Code of 1986, as amended (the "Code").

A. IRS Exempt Organizations Workplan for Fiscal Year 2006. On October 25, 2005, the Tax Exempt and Government Entities ("TEGE") division of the IRS released its workplan for the IRS fiscal year 2006, emphasizing a continuing increase in enforcement activities. The primary goals for fiscal year 2006 are to complete critical initiatives started in FY 2005, to perform analysis to better target noncompliant organizations, and to enhance enforcement efforts. The workplan contains a summary of FY 2005 activities, which noted that the Exempt Organizations Compliance Unit contacted 19,700 organizations during FY 2005, up from 9,500 in FY 2004. New critical initiatives planned for FY 2006 will focus on façade easements, conservation easements, charitable trusts, accommodation charities that facilitate abusive transactions, and hospitals (potentially on compensation and community benefit standards). The TEGE division will also continue to work on revising the Form 990 to increase transparency and improve its usefulness as a compliance tool. The workplan includes only limited guidance efforts for FY 2006, focused on donee reporting for car donations, down-payment assistance organizations, Section 501(c)(15) issues, Section 527(l) issues, and Section 529 qualified tuition programs.

In addition to the critical initiatives for FY 2006, discussed above, the workplan lists the following additional new or ongoing enforcement initiatives that will receive attention during FY 2006: (i) medical/dental resident FICA claims; (ii) credit union UBIT cases (approximately 60 state credit union cases are currently "in the examination stream"); (iii) tax-exempt bond issues; (iv) Section 527 issues; (v) completion of the political activities compliance initiative from the 2004 campaign season; (vi) disaster relief; and (vii) gaming.

B. Proposed Regulations on the Interaction of Sections 501(c)(3) and 4958. On September 9, 2005, Treasury published proposed regulations (REG-111257-05) aimed at clarifying the relationship between the substantive requirements for tax exemption under Section 501(c)(3) and the imposition of intermediate sanctions excise taxes under Section 4958. In particular, the proposed regulations address the process the IRS should use in deciding whether a Section 501(c)(3) organization should retain its exemption after it has been involved in an excess benefit transaction. The proposed regulations would add two new subsections to the Section 501(c)(3) regulations and a new subsection to the Section 4958 regulations.

The proposed regulations would add three new examples at Treas. Reg. § 1.501(c)(3)-(1)(d)(iii), illustrating the requirement that Section 501(c)(3) organizations serve a public rather than a private interest. The examples demonstrate that (i) an educational organization does not serve a public purpose when it focuses on the genealogical history of a single family; (ii) an art museum provides more than incidental private benefit when its sole activity is to exhibit and offer for sale works of promising local artists, paying 90% of sales proceeds to those artists; and (iii) an educational organization is operated for an impermissible private purpose when its sole activity is to conduct lectures and seminars on a program developed by an individual with significant payments and other benefits accruing to a company owned by that individual.

The meat of the proposed regulations is contained in a new subsection 1.501(c)(3)-(1)(g) of the Section 501(c)(3) regulations. This new subsection (g) emphasizes that Section 501(c)(3) organizations remain subject to the requirements of Section 501(c)(3) even though insiders and organization managers may be subject to Section 4958. New subsection (g) provides a non-exclusive list of factors that the IRS will consider when deciding whether to revoke the exemption of a 501(c)(3) organization that has been involved in an excess benefit transaction subject to Section 4958 penalties. Those factors include the following: (i) the size and scope of the organization's ongoing exempt activities before and after the excess benefit transaction(s); (ii) the size and scope of the excess benefit transaction(s) in relation to the organization's ongoing exempt activities; (iii) whether the organization has been involved in repeated excess benefit activities; (iv) whether the organization has implemented safeguards reasonably calculated to prevent future violations; and (v) whether the excess benefit transaction(s) have been corrected or the organization has made good faith efforts to seek correction. New subsection (g) also indicates that the IRS will be less likely to revoke exemption if the organization discovers the excess benefit transaction and takes action before the IRS discovers the violation. It adds that correction of the excess benefit transaction is never, by itself, enough to justify retention of exemption.

New subsection (g) contains five examples designed to illustrate the factors the IRS will consider in deciding whether to revoke the exemption of an organization that has been involved in an excess benefit transaction. These five examples will likely be the most cited provisions of the proposed regulations if the regulations are ultimately adopted. Following are summaries of the five examples:

Example 1. An art museum elects a new board of trustees in Year 3 with all of the new trustees being local art dealers. The museum begins using almost all its revenues to purchase art from its new trustees at excessive prices and then exhibits and offers those works for sale. The new trustees remain in control of the museum during all relevant periods. The example indicates that the organization should not retain its exemption because the excess benefit activities comprised almost all of the museum's activities, the size and scope of the excess benefits were significant in relation to the ongoing exempt activities, safeguards were not implemented to prevent future abuses, and there was no correction nor a good faith effort to seek correction.

Example 2. The facts are the same as in Example 1, except that in Year 4, the entire board of trustees resigns and is replaced by a representative community board of trustees, none of whom are in the business of buying or selling art. The museum stops offering all exhibited art for sale, stops purchasing art from current or former trustees, adopts a written conflict of interest policy, adopts written art valuation guidelines, implements a new educational program that grows more and more significant over time, and hires legal counsel to recover the excess amounts paid to the former trustees. Even though the excess benefit transactions were significant in comparison to the organization's Year 3 exempt activities, the example indicates that the organization should retain its exemption because its exempt activities become more significant in subsequent years and because of the actions taken to correct the violation and prevent future violations.

Example 3. In Year 5, an educational organization began paying personal expenses of its CEO, who was also its founder, and continued to do so through all relevant periods. The payments significantly reduced the funds available for the organization's educational activities. Certain members of the organization's board were aware of the payments, but the board did not terminate the CEO's employment and took no action to seek repayment or to stop the continued diversion. Instead, the organization claimed that the payments represented loans to the CEO even though there were no contemporaneous loan documents and there were never any payments of principal or interest. The example indicates that the organization's exemption should be revoked.

Example 4. An educational organization hired a construction company owned by its CEO to construct a significant addition to its existing building. The contract price substantially exceeded the fair market value of the work. Subsequently, but before the IRS commenced an examination of the organization, the board of trustees determined that the price was excessive. The board then promptly removed the CEO and terminated his employment, hired legal counsel to recover the excess payment, adopted a conflict of interest policy, and adopted new contract review procedures designed to prevent recurrences of the problem. The example indicates that the organization should retain its exemption.

Example 5. In Year 1, a large organization paid $2,500 of its CFO's personal expenses without reporting or otherwise treating such amounts as income to the CFO and without the CFO reporting such amounts as income. The organization continued to pay similar amounts of the CFO's personal expenses in future years, but treated and reported those payments as part of the CFO's compensation. The example indicates that the organization should retain its exemption because the amounts involved in the excess benefit transaction in Year 1 were de minimis and the excess benefit transaction was not repeated in future years. Presumably, the CFO's overall compensation was reasonable, although the example does not address that issue.

The proposed regulations also add new subsection 53.4958-2(a)(6) to the intermediate sanctions regulations. This new subsection clarifies that an organization whose application for exemption never results in an exemption is not subject to Section 4958. It also provides that an organization that has received an exemption but has that exemption revoked retroactively may remain subject to Section 4958 penalties for the years for which its exemption was revoked.

C. Senate Legislation Update. Chairman Grassley of the Senate Finance Committee successfully added an amendment to Senate Bill 2020 (The Tax Reform Act of 2005), which passed the Senate in November 2005. That amendment contains several of the proposals made by the Panel on the Nonprofit Sector in 2005 and other charitable reforms that have been under consideration by the Senate Finance Committee, although many of the reforms that were under consideration by the Senate Finance Committee over the last year and a half are not included in the bill.[2] The most significant exempt organization provisions in Senate Bill 2020 are as follows:

Charitable Contribution Deductions. The bill contains several amendments to the rules governing deductibility of charitable contributions. Non-itemizers would be allowed to deduct cash contributions over a $210 (single) or $420 (married filing jointly) floor. Contributions of certain literary, musical, artistic, and scholarly works by the creator would be deductible at fair market value. Deductions for contributions of cash or other monetary gifts would be allowed only if the taxpayer has retained a cancelled check or an adequate receipt from the donee.

Donor Advised Funds. The bill would define a donor advised fund generally as any organization where donors or their designees have, or may reasonably expect to have, advisory privileges regarding investments or grants. The bill would impose an aggregate 5% payout requirement on all donor advised fund entities and a minimum activity requirement of $250 (or more for larger funds) per year on each fund within the donor advised fund entity. An individual advised fund comprised of more than 10% of assets other than cash and marketable securities would be subject to additional payout requirements. Grants to other donor advised funds, supporting organizations, individuals, non-charities, non-operating foundations, and foreign organizations would be prohibited and, if made, would not count towards the 5% payout requirement. A 20% penalty (20% of the amount of the prohibited grant) would be imposed on any advisor who advised the organization to make such a prohibited grant. Additional restrictions, including non-deductibility of certain contributions, would be placed on certain donor advised funds. The bill would also add donors of advised funds, all advisors to such funds, and certain others to the list of disqualified persons with respect to a donor advised fund organization for Section 4958 purposes.

Supporting Organizations. The bill would impose the excess business holdings rules of Section 4943 on type III supporting organizations and certain type II supporting organizations. It would prohibit a type III supporting organization from making distributions

to donor advised funds, and it would impose a 5% payout requirement on all type III supporting organizations. The bill would require all organizations applying for status as type III supporting organizations to provide letters from each supported organization acknowledging its status as a supported organization. A type III supporting organization could support no more than five supported organizations. The bill would also cause any compensation, loan, or other payment transaction between a supporting organization and certain disqualified persons to be treated automatically as an "excess benefit" transaction under Section 4958.

Increased Penalties for Violation of Private Foundation Rules. First tier excise tax rates for all violations of private foundation rules in Chapter 42 would double, except for self-dealing first tier taxes involving excess compensation which would increase from 5% (per year) to 25% (per year).

Private Foundations Prohibited from Making Grants to Supporting Organizations. Private foundations would be prohibited from making grants to supporting organizations. Any such grants would fail to qualify as qualifying distributions under Section 4942 and would be taxable expenditures under Section 4945.

Private Foundation Investment Income Excise Tax. The bill would expand the definition of investment income subject to the Section 4940 excise tax to include "income from sources similar" to the existing types of income subject to the tax and capital gains from such sources.

Annual Notices Required for Small Organizations. The bill would require small exempt organizations not required to file Form 990 to file a short annual notice with the IRS and to notify the IRS upon the organization's termination. The notice requirement would apparently not apply to churches, which are not required to file Form 990 regardless of the amount of their receipts. An organization could lose its exemption for failing to file the notice for three successive years.

Disclosure and Certification of UBIT Returns. The bill would subject Forms 990-T to the same disclosure requirements applicable to Forms 990 and 990-PF. The bill would also require each organization filing Form 990-T to include a statement from an independent auditor or independent counsel that (i) the information in the return has been reviewed by the auditor or counsel, (ii) to the best of such person's knowledge the information is accurate, and (iii) to the best of such person's knowledge the allocation of expenses between unrelated activities and exempt activities complies with the requirements of Section 512.

IRS Disclosures to State Officials. The bill would loosen the restrictions the IRS is currently subject to with respect to sharing information with state officials.

As of the writing of this article in early December 2005, it remains to be seen whether the House will agree to some or all of the exempt organization provisions in Senate Bill 2020. Earlier, on October 31, 2005, House Ways and Means Committee Democratic tax counsel John Buckley told an AICPA panel that the Senate Finance Committee's proposed reforms (in its June 2004 White Paper) are "off the table" and that they never had any support in the House. However, the reforms of Senate Bill 2020 are not as extensive as the June 2004 White Paper, and Mr. Buckley indicated that the scrutiny of nonprofits is not over.

D. Political Activities of Churches. In early December 2005, Marvin Friedlander, chief of exempt organizations rulings and agreements at the IRS, told an ALI-ABA audience that the IRS is working on plain language guidance for churches regarding political activities. Mr. Friedlander said that the guidance would likely focus on examples of what is and is not permissible in the area. Mr. Friedlander also defended the IRS's 2004 crackdown on charitable organizations, including churches, involved in political activities. As of late November 2005, the IRS still had approximately 130 cases open from that 2004 initiative, with approximately 50 of those cases involving churches. Mr. Friedlander told the ALI-ABA audience that the IRS has been and will continue to be impartial in enforcing the political intervention prohibition of Section 501(c)(3).

E. IRS Excessive Compensation Initiative. IRS officials said in late 2005 that the IRS would issue a report in September 2006 on its compensation initiative. The officials said more than 1,800 exempt organizations were contacted, with 1,225 compliance check letters (which fall short of being an examination) and 600 single issue examinations. The officials said the initiative has revealed widespread use of insider loans and also revealed undocumented loans and fragmented compensation among related organizations (resulting in compensation that is reported in pieces rather than as a whole).

F. IRS Taking Months to Assign Applications for Exemption to Reviewers. The IRS's focus on enforcement initiatives is taking a toll on other functions of the TEGE division. As of December 2005, the IRS reportedly had a significantly reduced staff of personnel reviewing applications for exemption compared to recent years, while the number of applications continues to grow. Accordingly, applications for Section 501(c)(3) exemption are now routinely sitting for six or more months before being assigned to a reviewer, other than the small minority of applications that are approved by the initial IRS screener. Based on recent statements made by IRS personnel, this situation is unlikely to change in 2006. It does appear, however, that the IRS may no longer be holding all applications for exemption that have been filed for Section 509(a)(3) supporting organizations.

G. Miscellaneous. The IRS released a draft Form 990 in October 2005, that expands the form by two pages and adds new questions. Most new questions focus on compensation, including for service providers who do not provide "professional" services. The new form also asks whether the organization has a written conflict of interest policy. In November 2005, the House Ways and Means Committee conducted hearings into whether credit unions should continue to be exempt from federal income taxes. IRS officials said in November 2005, that they are proposing revocation of exemption of about half (measured by gross receipts) of the nation's tax-exempt credit counseling organizations.

ENDNOTES

1 Tyree Collier, Jenkens & Gilchrist, 1445 Ross Ave., Ste. 3200, Dallas, Texas 75202.

2 The Panel on the Nonprofit Sector released its main report in June 2005. See the October 2005 issue of *The Texas Tax Lawyer* for a summary of those recommendations. The Panel then released a report with additional recommendations in September 2005. The most significant recommendations in the September report were (i) for Treasury to clarify that approvals by state or local governments and requirements of a trust instrument will not automatically render compensation reasonable, and (ii) for Congress to not make Form 990-T publicly available, but rather increase the amount of UBIT-related information reported on the publicly-available Forms 990 and 990-PF.

TCOMMENTS ON PROPOSED GUIDANCE FOR EXCHANGES OF PARTNERSHIP EQUITY FOR SERVICES

Editor's Note: The following comments were submitted to Treasury and the IRS on behalf of the Tax Section on August 22, 2005. The comments are reprinted here in their entirety.

State Bar of Texas

Section of Taxation

August 22, 2005

Report No. 1 - Proposed Regulations relating to the tax treatment of certain transfers of partnership equity in connection with the performance of services.[1]

I. Introduction

On May 24, 2005, the Treasury Department and the Internal Revenue Service issued proposed regulations, REG-105346-03, 70 F.R. 29675-29683 (the "*Proposed Regulations*") and Notice 2005-43, 2005-24 IRB 1 (together with its accompanying revenue procedure, the "*Notice*") providing guidance relating to the tax treatment of certain transfers of partnership equity in connection with the performance of services. This report provides comments on the Proposed Regulations and the Notice. The comments provided herein represent the views of the persons that have reviewed these comments and do not necessarily represent the position of the State Bar of Texas or its Section of Taxation.

Although many of the person reviewing these comments have clients that would be affected by the federal tax principles addressed by these comments and frequently advise clients on the application of such principles, none of the persons reviewing these comments (or the firm or organization to which such person 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.

Our comments primarily relate to:

1. the capital account adjustments to be made upon the issuance of a partnership interest in exchange for services;

2. the use of notional tax items upon the forfeiture of an unvested interest in a partnership;

3. the requirement that all partners in an existing partnership sign an instrument reflecting their consent to the use of the liquidation value for the issuance of partnership interests in exchange for services; and

4. the treatment of a partnership interest as transferred in anticipation of a subsequent disposition when the interest merely is subject to a right to buy or sell during the two-year period immediately following the transfer.

II. Summary of the Proposed Regulations

A. *In General*

Partnerships issue a variety of interests in connection with the performance of services. These interests include interests in partnership capital or profits, value appreciation rights, options to acquire interests and convertible interests. On January 22, 2003, the Treasury Department and the IRS published proposed regulations regarding the federal income tax consequences of noncompensatory partnership options, convertible equity and convertible debt. In the preamble to those proposed regulations, the Treasury Department and the IRS requested comments on the proposed amendment to Treas. Regs. sec. 1.721-1(b)(1) that was published in the Federal Register on June 3, 1971 (36 FR 10787), and on the federal income tax consequences of the issuance of partnership capital interests in connection with the performance of services and options to acquire such interests. In response to the comments received, the Treasury Department and the IRS withdrew the proposed amendment to Treas. Regs. sec. 1.721-1(b)(1) and issued the Proposed Regulations, which prescribe rules on the application of section 83[2] to partnership interests and the federal income tax consequences associated with the transfer, vesting and forfeiture of partnership interests transferred in connection with the performance of services.

B. *Application of Section 83 to Partnership Interests*

Section 83 generally applies to a transfer of property by one person to another in connection with the performance of services. The courts have held that a partnership capital interest is property for purposes of section 83. *Mark IV Pictures, Inc. v. Commissioner*, 60 T.C.M. 1171 (1990) *aff'd.*, 969 F.2d 669 (8th Cir. 1992); *see Schulman v. Commissioner*, 93 T.C. 623 (1989) (holding that section 83 governs the issuance of an option to acquire a partnership interest as compensation for services provided as an employee); *Kenroy, Inc. v. Commissioner*, T.C. Memo 1984-232. Consistent with these court decisions, the Proposed Regulations provide that a partnership interest is property within the meaning of section 83, and that the transfer of a partnership interest in connection with the performance of services is subject to section 83.

The Proposed Regulations apply section 83 to both partnership capital interests and partnership profits interests. Although the application of section 83 to partnership profits interests has been the subject of controversy, *see, e.g., Campbell v. Commissioner*, T.C. Memo 1990-162, *aff'd in part and rev'd in part*, 943 F.2d 815 (8th Cir. 1991); St. John v. United States, 84-1 USTC 9158 (C.D. Ill. 1983), the Treasury Department and the IRS indicated in the preamble of the Proposed Regulations that they do not believe that there is a substantial basis for distinguishing among partnership interests for purposes of section 83.

Section 83(b) allows an election to be made by a person who receives, in connection with the performance of services, property that either is non-transferable or is subject to a substantial risk of forfeiture (sometimes for convenience collectively referred to together simply as a "substantial risk of forfeiture"). Any person making this election must include in gross income the difference between: (A) the fair market value of the property at the time of transfer (determined without regard to a restriction other than a restriction which by its terms will never lapse); and (B) the amount paid for such property. This election must be made within 30 days of the date of the transfer of the property to the service provider.

Consistent with the principles of section 83, the Proposed Regulations provide that, if in connection with the performance of services a service provider receives a partnership interest that is subject to a substantial risk of forfeiture and the service provider does not make a section 83(b) election, then the service provider is not treated as a partner until the substantial risk of forfeiture lapses. If a section 83(b) election is made with respect to such an interest, however, the service provider will be treated as a partner at the time the interest is received.

These principles differ from Revenue Procedures 93-27 (1993-2 C.B. 343), and 2001-43 (2001-2 C.B. 191). Specifically, under Revenue Procedure 2001-43, if a partnership profits interest is transferred in connection with the performance of services, then the holder of the partnership interest may be treated as a partner even if no section 83(b) election is made, provided that certain conditions are met.

The preamble to the Proposed Regulations indicate that the Treasury Department and the IRS believe certain changes to the regulations under both subchapter K and section 83 are needed to coordinate the principles of subchapter K with the principles of section 83. Among the changes in the Proposed Regulations are: (1) conforming the subchapter K rules to the section 83 timing rules regarding the timing of income recognition by the service provider and deduction by the service recipient with respect to the transfer of the property; (2) revising the section 704(b) regulations to take into account the fact that allocations with respect to an interest subject to a substantial risk of forfeiture may, in fact, be forfeited; and (3) providing that a partnership generally recognizes no gain or loss on the transfer of an interest in the partnership in connection with the performance of services for that partnership. In addition, the Proposed Regulations indicate that the Treasury Department and the IRS believe Revenue Procedures 93-27 and 2001-43, which generally provide for nonrecognition by both the partnership and the service provider on the transfer of a profits interest in the partnership for services performed for that partnership, must be modified to be consistent with the Proposed Regulations. Accordingly, in conjunction with the Proposed Regulations, the IRS issued the Notice. The Notice contains a proposed revenue procedure that, when finalized, will obsolete Revenue Procedures 93-27 and 2001-43.

C. *Timing of Partnership's Deduction*

Except as otherwise provided in Treas. Regs. sec. 1.83-6(a)(3), if property is transferred in connection with the performance of services, then the service recipient's deduction, if any, is allowed only for the taxable year of that person in which or with which ends the taxable year of the service provider in which the amount is included as compensation. See section 83(h). In contrast, under section 706(a) and Treas. Regs. sec. 1.707-1(c), guaranteed payments described in section 707(c) are included in the partner's income in the partner's taxable year within or with which ends the partnership's taxable year in which the partnership deducts (or capitalizes) the payments. Under current Treas. Regs. sec. 1.721-1(b)(2), an interest in partnership capital issued by the partnership as compensation for services rendered to the partnership is treated as a guaranteed payment under section 707(c).

Under the Proposed Regulations, additional partnership interests issued to existing partners for services rendered to the partnership are treated as guaranteed payments under section 707. The Proposed Regulations provide that the section 83 timing rules override the timing rules of section 706(a) and Treas. Regs. sec. 1.707-1(c) to the extent they are inconsistent. Accordingly, if a partnership transfers property to a partner in connection with the performance of services, the timing and the amount of the related income inclusion and deduction is determined by section 83 and the regulations thereunder.

D. *Allocation of Partnership's Deduction*

The Proposed Regulations provide guidance regarding the allocation of the partnership's deduction for the transfer of a partnership interest in connection with the performance of services.

Section 706(d)(1) provides generally that, if, during any taxable year of a partnership, there is a change in any partner's interest in the partnership, each partner's distributive share of any item of income, gain, loss, deduction or credit of the partnership for such taxable year shall be determined by the use of any method prescribed by regulations that takes into account the varying interests of the partners in the partnership during the taxable year. Regulations have not yet been issued describing the rules for taking into account the varying interests of the partners in the partnership during a taxable year. Treas. Regs. sec. 1.706-1(c)(2)(ii) provides that, in the case of a sale, exchange or liquidation of a partner's entire interest in a partnership (or death of a partner), the partner's share of partnership items for the taxable year may be determined by either: (1) closing the partnership's books as of the date of the transfer (closing of the books method); or (2) allocating to the departing partner that partner's pro rata part of partnership items that the partner would have included in the partner's taxable income had the partner remained a partner until the end of the partnership taxable year (proration method). The Proposed Regulations indicate that the Treasury Department and the IRS believe that section 706(d)(1) adequately ensures that partnership deductions that are attributable to the portion of the partnership's taxable year prior to a new partner's entry into the partnership are allocated to the historic partners.

Section 706(d)(2), however, places additional limits on how partnerships may allocate these deductions. Under section 706(d)(2)(B), payments for services by a partnership using the cash receipts and disbursements method of accounting are allocable cash basis items. Under section 706(d)(2)(A), if during any taxable year of a partnership there is a change in any partner's interest in the partnership, then (except to the extent provided in regulations) each partner's distributive share of any allocable cash basis item must be determined under the proration method. To allow partnerships to allocate deductions with respect to property transferred in connection with the performance of services under a closing of the books method, the Proposed Regulations provide that section 706(d)(2)(A) does not apply to such a transfer.

E. *Accounting for Compensatory Partnership Interests*

1. *Transfer of compensatory partnership interest*

Under the Proposed Regulations, the service provider's capital account in the partnership is increased by the amount the service provider takes into income under section 83 as a result of receiving the interest, plus any amounts paid for the interest.

The Notice and its accompanying proposed revenue procedure allow a partnership, the partners, and the service provider to elect to treat the fair market value of a partnership interest as equal to its liquidation value at the time of issuance. If such an election is made, the capital account of a service provider receiving a partnership interest in connection with the performance of services is increased by the liquidation value of the partnership interest received.

2. *Forfeiture of certain compensatory partnership interests*

If an election under section 83(b) has been made with respect to a partnership interest that is subject to a substantial risk of forfeiture, the holder of the interest may be allocated partnership items that may later be forfeited. For this reason, allocations of partnership items while the interest is substantially nonvested cannot have economic effect and must be allocated in accordance with the partner's interest in the partnership. Under the Proposed Regulations, such allocations will be treated as being in accordance with the partners' interests in the partnership if: (a) the partnership agreement requires that the partnership make forfeiture allocations if the interest for which the section 83(b) election is made is later forfeited; and (b) all material allocations and capital account adjustments under the partnership agreement not pertaining to a partnership interest that is subject to a substantial risk of forfeiture for which a section 83(b) election has been made are recognized under section 704(b). This safe harbor does not apply if, at the time of the section 83(b) election, there is a plan that a partnership interest that is subject to a substantial risk of forfeiture will be forfeited. All of the facts and circumstances (including the tax status of the holder of the substantially nonvested interest) will be considered in determining whether there is a plan that the interest will be forfeited. In such a case, the partners' distributive shares of partnership items shall be determined in accordance with the partners' interests in the partnership under Treas. Regs. sec. 1.704-1(b)(3).

Generally, forfeiture allocations are allocations to the service provider of partnership gross income and gain or deduction and loss (to the extent such items are available) that equal the prior distributions and items (to the extent available) that offset prior allocations of partnership items with respect to the forfeited partnership interest. These rules are designed to ensure that any partnership income (or loss) that was allocated to the service provider prior to the forfeiture is offset by allocations on the forfeiture of the interest. Also, to carry out the prohibition under section 83(b)(1) on deductions with respect to amounts included in income under section 83(b), these rules generally cause a forfeiting partner to be allocated partnership income for any distributions to the partner that reduced the partner's basis in the partnership below the amount included in income under section 83(b).

Forfeiture allocations may be made out of the partnership's items for the entire taxable year in which the interest is forfeited. In determining the gross income of the partnership in the taxable year of the forfeiture, the rules of Treas. Regs. sec. 1.83-6(c) apply, which generally requires the amount of prior deductions attributable to the transfer of property to the service provider to be included in income by the service recipient. As a result, the service recipient partnership generally will have gross income in the taxable year of the forfeiture equal to the amount of its allowable deduction when it transferred the interest as a result of the service provider partner making of the section 83(b) election, regardless of the fair market value of the partnership's assets at the time of forfeiture.

In certain circumstances, the partnership will not have enough income and gain to fully offset prior allocations of loss to the forfeiting service provider. The proposed revenue procedure includes a rule that requires the service provider to recapture its losses prior to the forfeiture of the interest to the extent that those losses are not recaptured through forfeiture allocations of income and gain to the service provider. This rule does not provide the other partners in the partnership with the opportunity to increase their shares of partnership loss (or reduce their shares of partnership income) for the year of the forfeiture by the amount of losses that are recaptured by the forfeiting service provider.

In other circumstances, the partnership will not have enough deductions and losses to fully offset prior allocations of income to the forfeiting service provider. In such a case, section 83(b)(1) may prohibit the service provider from claiming a loss with respect to partnership income that was previously allocated to the service provider. A forfeiting partner is entitled to a loss for any basis in a partnership that is attributable to contributions of money or property to the partnership (including amounts paid for the interest) remaining after the forfeiture allocations have been made. See Treas. Regs. sec. 1.83-2(a).

F. *Valuation of Compensatory Partnership Interests*

Section 83 generally provides that the recipient of property transferred in connection with the performance of services recognizes income equal to the fair market value of the property-disregarding lapse restrictions-at the first time the rights of the recipient are not subject to a substantial risk of forfeiture. *See Schulman v. Commissioner*, 93 T.C. 623 (1989). Some authorities have concluded that, under the particular facts and circumstances of the case, a partnership profits interest has only a speculative value or that the fair market value of a partnership interest should be determined by reference to the liquidation value of that interest. *See Treas*. Regs. sec. 1.704-1(e)(1)(v); *Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991); *St. John v. United States*, 1984-1 U.S.T.C. 9158 (C.D. Ill. 1983); *but see Diamond v. Commissioner*, 492 F.2d 286 (7th Cir. 1974)

(holding under pre-section 83 law that the receipt of a profits interest with a determinable value at the time of receipt resulted in immediate taxation); *Campbell v. Commissioner*, T.C. Memo 1990-162, *aff'd in part and rev'd in part*, 943 F.2d 815 (8th Cir. 1991) (similar holding).

In existing guidance, the Treasury Department and the IRS have provided that if certain requirements are satisfied, it is appropriate to allow partnerships and service providers to value partnership interests based on liquidation value. See Revenue Procedure 93-27, 1993-2 C.B. 343 and Revenue Procedure 2001-43, 2001-2 C.B. 191. This approach ensures consistency in the treatment of partnership profits interests and partnership capital interests, and accords with other regulations issued under subchapter K, such as the regulations under section 704(b).

In accordance with the Proposed Regulations, the revenue procedure proposed in the Notice provides additional rules that partnerships, partners, and persons providing services to the partnership in exchange for interests in that partnership would be required to follow when electing to treat the fair market value of those interests as being equal to the liquidation value of those interests. For this purpose, the liquidation value of a partnership interest is the amount of cash that the holder of that interest would receive with respect to the interest if, immediately after the transfer of the interest, the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles associated with the partnership's operations) for cash equal to the fair market value of those assets, and then liquidated.

G. *Application of Section 721 to Partnership on Transfer*

As a general rule, if appreciated property is used to pay an obligation, gain on the property is recognized. Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940); *United States v. Davis*, 370 U.S. 65 (1962). The Proposed Regulations indicate that the Treasury Department and the IRS believe, however, that partnerships should not be required to recognize gain on the transfer of a compensatory partnership interest. Therefore, the Proposed Regulations provide that partnerships are not taxed on the transfer of a compensatory partnership interest or, if applicable, upon the lapse of a substantial risk of forfeiture. Under Treas. Regs. sec. 1.704-1(b)(4)(i) (reverse section 704(c) principles), the historic partners generally will be required to recognize any income or loss attributable to the partnership's assets only as those assets are sold, depreciated, or amortized.

The rule providing for nonrecognition of gain or loss does not apply to the transfer or substantial vesting of an interest in an eligible entity, as defined in Treas. Regs. Sec. 301.7701-3(a), that becomes a partnership under Treas. Regs. sec. 301.7701-3(f)(2) as a result of the transfer or substantial vesting of the interest. *See McDougal v. Commissioner*, 62 T.C. 720 (1974) (holding that the service recipient recognized gain on the transfer of a one-half interest in appreciated property to the service provider, immediately prior to the contribution by the service recipient and the service provider of their respective interests in the property to a newly formed partnership).

III. <u>Comments on the Proposed Regulations</u>

A. *In General*

The Committee believes, in general, that the Proposed Regulations provide clear and sensible rules for the taxation of the service provider, the partnership and the historic partners upon the issuance of a partnership interest to the service provider in exchange for services rendered by the service provider to the partnership. With respect to additional issues we believe the Proposed Regulations should address and, perhaps, should resolve differently, we submit the following comments.

B. *Comments*

1. *Capital account adjustments upon issuance of partnership interest in exchange for services*

When a service provider receives a partnership interest in exchange for services rendered to the partnership, the Proposed Regulations take the approach that the amount of compensation income recognized by the service provider, the amount of the compensation deduction recognized by the historic partners and the amount by which the service provider's capital account is credited should all be equal. The Proposed Regulations also take the approach that these amounts should be equal to and determined by the fair market value of the partnership interest received by the service provider.

Contrary to the approach taken in the Proposed Regulations, certain commentators referred to in the Proposed Regulations suggest that the amount included in the service provider's income under section 83 may differ from the amount of capital that the partnership has agreed to assign to the service provider with respect to such services. These commentators suggest that the substantial economic effect safe harbor in the section 704(b) regulations should be amended to allow partnerships to reallocate capital between the historic partners and the service provider to reflect the economic agreement of the parties.

For the reasons discussed below, we generally agree with these commentators and are concerned that, if the liquidation value safe harbor under the Proposed Regulations is not elected or cannot be elected under the Notice, the Proposed Regulations may inadvertently alter the economic agreement of the parties if they comply with both the Proposed Regulations and the substantial economic effect safe harbor in the section 704(b) regulations.

(i) *The Proposed Regulations do not take into account the economic reality that the fair market value of partnership interest and capital account balances are not economic equivalents*

The approach taken in the Proposed Regulations would generally be sound tax policy because (i) the income recognized by the service provider and the deduction recognized by the historic partners offset each other and (ii) the increase in the service provider's capital account and the decrease in the historic partners' capital accounts offset each other. We are concerned, however, that this approach (i) does not take into account the economic reality that a partner's capital account balance (assuming all assets are reflected on the partnership's books at fair market value) and the fair market value of his partnership interest may not be equal and (ii) would have the effect of treating partners who contribute services differently than partners who contribute property.

Regardless of whether a partner contributes property or services and whether he is a new partner or a long-time

partner, his capital account balance and the fair market value of his partnership interest may not be equal for many reasons, including lack of control and lack of marketability discounts that may apply in determining the fair market value of the partnership interest. Accordingly, we believe that limiting the capital account of a service provider to the value of the partnership interest received is not appropriate because it is not economically equivalent with such value.

Under the Proposed Regulations, a service provider's capital account is credited with the value of his partnership interest, which is inconsistent with the section 704(b) regulations that apply to property contributions. Under the section 704(b) regulations, the capital account of a partner who contributes property is credited with the fair market value of the property contributed, not the value of the partnership interest received. We believe that there is no rationale for treating a partner who contributes property and a partner who contributes services differently under the section 704(b) regulations. Accordingly, we believe that the Proposed Regulations are an inappropriate departure from the section 704(b) regulations and will result in partners who contribute property and partners who contribute services being treated differently without there being a rationale for such different treatment.

Even assuming that a partner's capital account balance and the fair market value of the partner's partnership interest are economic equivalents, we are concerned with the practical problem that a partnership interest generally cannot be valued without first determining the partner's capital account balance (i.e., his share of partnership capital). As such, we believe that crediting the service provider's capital account with the value of the partnership interest is counter-intuitive, because the value of a partnership interest often derives, at least in part, from the partner's capital account balance. We believe that such approach will lead to disputes between taxpayers and the IRS, because traditional valuation methods cannot be used.

(ii) *The approach taken in the Proposed Regulations may lead to economic distortions*

We are also concerned that the approach in the Proposed Regulations may lead to economic distortions if the service provider, the partnership and the historic partners comply with both the Proposed Regulations and the substantial economic effect safe harbor in the section 704(b) regulations. Our concern is illustrated in the following example.

> Partners A and B each contribute $100 to partnership P, and P purchases blackacre for $200. Assume P's partnership agreement complies with the substantial economic effect safe harbor provided in the section 704(b) regulations and that all items of income, gain, loss and deduction are allocated equally among the partners. Two years after acquiring blackacre, when blackacre (P's sole asset) is worth $300, A and B admit C as a partner in exchange for the services rendered by C to P, and no election is made to use the liquidation value safe harbor under the Notice. A, B and C intend for each to have a one-third interest in P (i.e., equal allocations of income, gain, loss and deduction and equal capital account balances). As a result, following the revaluation of blackacre upon C's admission to P, A, B and C each expect to have a $100 capital account balance. C's interest is subject to voting restrictions and limitations on assignment and based on recognized valuation principles, including lack of marketability and lack of control discounts, C's interest has a fair market value of $50.

Notwithstanding the intent of A, B and C that they have equal capital accounts, the Proposed Regulations require that C's initial capital account balance be $50 and that A and B each have a capital account balance of $125, determined as follows. C would recognize $50 of taxable income, and A and B would each recognize a $25 deduction. Upon the revaluation of the partnership's assets under the section 704(b) regulations, the $100 of unrealized gain attributable to blackacre would be allocated to A and B, the historic partners. After the foregoing allocations, each of A and B would have a capital account balance of $125 (i.e., $100 (the balance before any adjustment), plus $50 (the share of unrealized gain from the revaluation), minus $25 (share of compensation deduction)) and C would have a capital account balance of $50, the value of C's partnership interest. If P liquidates immediately following the admission of C, A and B would each receive $125, while C would receive only $50. As a result, if A, B and C comply with the Proposed Regulations and liquidate in accordance with positive capital accounts as required by the substantial economic effect safe harbor of the section 704(b) regulations, the Proposed Regulations have altered the economic deal of A, B and C because C does not have a capital account balance of $100.

Although we agree that the taxable income recognized by a service provider on receipt of a partnership interest in connection with the performance of services is the fair market value of the partnership interest received under section 83, we disagree with the requirement of the Proposed Regulations that the value of the partnership interest (plus any amounts paid for the interest) determines the amount by which the service provider's capital account should be increased. We believe that the amount of the service provider's capital account should be determined by the agreement between or among the partners.[3]

We acknowledge that the economic distortion cause by the Proposed Regulations in the above example could be eliminated if the liquidation value safe harbor under the Proposed Regulations were elected. However, we also acknowledge that, under the safe harbor, C's income recognized under section 83 would be increased (we believe inappropriately) by $50 (i.e., the amount by which C's capital account of $100 exceeds the fair market value of his partnership interest of $50). We do not believe the liquidation value safe harbor should be required, whether by rule or economic compulsion, because partnership interests would then be treated differently than other property under section 83, such as stock where the amount of income recognized is limited to the value of the stock received. Additionally, in certain circumstances, the liquidation value election cannot be made under the Notice-most notably, in large partnerships, by failing to satisfy the requirement that all partners consent to the election.

Accordingly, we believe that the liquidation value safe harbor should remain an option and that the Proposed Regulations should include a mechanism to eliminate the disparity between the amount of income recognized under section 83 by the service provider and the capital account balance intended to be transferred to the service provider. Discussed below are two alternatives that the members of the Committee have considered to eliminate this disparity.

(a) *Some Committee members believe that rules similar to the rules in the Non-Compensatory Option Regulations should be adopted*

Some members of the Committee believe that the disparity between the income recognized by the service provider under section 83 and the capital account balance the partners have agreed to assign to the service provider can be eliminated by adjusting the capital account balances of the service provider in a manner similar to that taken in proposed Treas. Regs. sec. 1.704-1(b)(2)(iv)(5) (the "Non-compensatory Option Regulations"). Following this approach, the unrealized gain in the assets of the partnership would not be booked into the historic partners' capital accounts immediately prior to the admission of the service provider. Rather, upon the issuance of the partnership interest in exchange for services, the unrealized gain would be allocated to the service provider to the extent necessary for the service provider to have a capital account balance equal to that intended by the parties. If unrealized gain is insufficient to make the adjustment, then items of income and gain would be specially allocated to the service provider until his capital account balance equals the balance intended by the partners.

To illustrate this approach, consider the example stated above. C would still recognize $50 of income, and A and B would each still recognize a $25 deduction. However, upon the revaluation of P's assets under the section 704(b) regulations, the $100 of unrealized gain attributable to blackacre would be allocated $50 to C to bring C's capital account balance to $100, and the remaining $50 of unrealized gain in blackacre would be allocated to A and B. After the foregoing allocations, each of A and B would have a capital account balance of $100 (i.e., $100 (the balance before any adjustment), plus $25 (the unrealized share of gain from the revaluation), minus $25 (share of compensation deduction)) and C would have a capital account balance of $100 (i.e., $50 (value of the interest), plus $50 (unrealized share of gain)). The capital account balances of A, B and C now comports with their economic agreement.

Those members believe the foregoing allocations are consistent with both the Proposed Regulations and the spirit of the substantial economic effect safe harbor in the section 704(b) regulations as adjusted by the Non-Compensatory Option Regulations and would properly reflect and tax the economic relationship of the partners. C would be taxed on the fair market value of the interest in P, which is consistent with the treatment of other property received in exchange for services under section 83. Also, C would ultimately be taxed on the $50 of built-in gain in blackacre under the principles applicable to reverse section 704(c) allocations or upon the special allocation of items of income and gain. A and B would be in the economic position they had intended, which is that each of them would have a one-third interest in the capital and profits of P following the issuance of the interest in P to C.

(b) *Other Committee members believe that rules already exists under the section 704(b) regulations to eliminate the disparity between the amount of income recognized by the service provider and his capital account balance*

Within the Committee, some members expressed concern that the approach used in the Non-Compensatory Option Regulations discussed above may not be appropriate for partnership interests issued in exchange for services. Those Committee members believe that the approach in the Non-Compensatory Option Regulations is appropriate for non-compensatory options because such options, like options on other property, entitle the option holder the right to a portion of the appreciation in the partnership's assets after the option is granted. Those Committee members believe, however, that the rationale for the Non-Compensatory Option Regulations does not support treating persons who contribute services in exchange for partnership interests differently than persons who contribute property in exchange for partnership interests. With respect to persons who contribute property, the unrealized gain or loss in the partnership's existing assets would be allocated under the section 704(b) regulations to the historic partners upon a revaluation, which has been the long standing rule to make sure that the historic partners ultimately realize and are taxed on such appreciation. But if rules similar to the Non-Compensatory Option Regulations are adopted, the unrealized gain in the partnership's existing assets would be allocated to the service provider first.

These Committee members believe the rules that already exist under subchapter K are sufficient to properly tax the issuance of a partnership interest in, and the subsequent operations of, a partnership under these circumstances. Rather than adopting rules similar to the Non-Compensatory Option Regulations, these Committee members would provide a capital account balance for the service provider and the other partners consistent with their economic agreement. Using the example above as an illustration, C's initial capital account balance would be $100. The disparity between the $50 of income recognized under section and the $100 capital account balance the service provider is credited with would be accounted for and taxed under the rules of subchapter K. The additional $50 amount in this example would not necessarily be taxed as compensation income to C, but rather, would be taxed in the same manner as if a partner contributes property for a partnership interest having a value different from the partner's initial capital account balance.

Notwithstanding the disagreement among the members of the Committee as to which of the above mechanisms is appropriate, the Committee is concerned that, absent a mechanism to adjust a service provider's capital account to the economic agreement of the partners, the Proposed Regulations may essentially require the use of the liquidation value safe harbor under the Proposed Regulations if the partners desire to stay within the substantial economic safe harbor of the section 704(b) regulations and to avoid the economic distortions the rules in the Proposed Regulations will cause, as illustrated in the example above. We are particularly concerned about situations where the liquidation value safe harbor cannot even be elected under the Notice because the partnership interest is not a "Safe Harbor Partnership Interest" as defined in the Notice.

2. *Whether the Proposed Regulations should require or allow partnerships to create notional tax items to make forfeiture allocations where the partnership does not have enough actual tax items to make such allocations*

In the preamble to the Proposed Regulations, the Treasury Department and the IRS requested comments as to whether the regulations should require or allow partnerships to create notional tax items to make forfeiture allocations where the partnership does not have enough actual tax items to make the forfeiture allocations. The preamble explains that the forfeiture allocation rules are designed to ensure that any partnership income (or loss) that was allocated to the service

provider prior to the forfeiture of the partnership interest is offset by allocations upon such forfeiture. In other words, the goal of the forfeiture allocation rules is to place the service provider in the tax position he would have been had he not been allocated tax items from the partnership with respect to such forfeited partnership interest.

As explained below, the proposed forfeiture allocation rules may not achieve the stated goal because (i) the partnership may not have a sufficient amount of tax items in the year of forfeiture to offset the amount of prior allocations made to the service provider, and (ii) even if the partnership does have a sufficient amount of tax items in the year of forfeiture, the forfeiture allocation rules do not take into account the character of the previous allocations (e.g., capital versus ordinary). Similar to the remedial allocation method in Treas. Regs. sec. 1.704-3(d), which allows partnerships to elect to create offsetting remedial items to eliminate distortions caused by the ceiling rule, we believe that any distortions resulting from the situations described above could be eliminated if partnerships were able to elect to create offsetting notional tax items that take into account the character of the prior allocations made to the service provider.[4]

(i) *A partnership should be allowed to create offsetting notional tax items*

In the preamble, the Treasury Department and the IRS acknowledged that, in certain circumstances, the partnership will not have enough items of income, gain, loss or deduction in the year of forfeiture to fully offset the amount of prior allocations made to the service provider. The amount of forfeiture allocations is determined by comparing the service provider's cumulative net distributions (*i.e.*, the excess, if any, of cumulative distributions received over the amount paid for partnership interest) to the cumulative net income (or loss) allocated to the service provider with respect to such forfeited partnership interest.[5] Depending on whether the resulting amount is positive (*i.e.*, net distributions exceeds net income) or negative (*i.e.*, net income exceeds net distributions), the service provider is allocated a pro rata portion of partnership gross income and gain available in such year equal to the positive amount or a pro rata portion of partnership gross deduction and loss available in such year equal to the negative amount.

Since tax items available only in the year of forfeiture can be used to make the forfeiture allocations, the partnership may not be able to fully offset the positive or negative amount with forfeiture allocations. For example, assume the facts are the same as those in Example 29 of the Proposed Regulations, except that the LLC did not have any items of deduction in year 6 to offset the prior net income allocations to SP of $30. Under the example with this changed fact, SP is over taxed by $30 (assuming section 83(b)(1) disallows a loss on the forfeiture) and A and B are under taxed by $30 in the aggregate.

If the LLC was able to elect to create notional tax items of $30 of deduction to be allocated to SP and a corresponding notional item of $30 of income to be allocated to A and B in the aggregate, the tax positions of SP, A and B would be the same as if SP were never treated as a partner of the LLC. Accordingly, we believe that the forfeiture allocation rules should include an election that would allow partnerships to create notional tax items to eliminate distortions caused when a partnership does not have enough tax items in the year of forfeiture to offset prior allocations made to the service provider.

(ii) *Partnerships should be allowed to take into account the character of prior allocations to be offset by forfeiture allocations*

Since the Proposed Regulations provide that the forfeiture allocations consist of a pro rata portion of taxable items for the year of forfeiture, rather than matching the character of the previous allocations, the service provider could be allocated items of one character for which the service provider later receives forfeiture allocations of another character. For example, assume the facts are the same as Example 29 in the Proposed Regulations, except that all of SP's prior allocations of $30 were long-term capital gains. Under this example with this changed fact, SP would have paid tax on the prior allocations at long-term capital gains rates, but would receive an allocation of ordinary deduction in the year of forfeiture of $30. By analogy, with respect to section 704(c), the partners and the partnership are specifically prohibited from making any curative or remedial allocations that are not of the same kind. Therefore, to maintain consistency under subchapter K, if the LLC were able to create notional tax items taking into account the character of the prior allocations made to SP, SP's prior long-term capital gains of $30 would be offset with a long-term capital loss of $30, with A and B being allocated $30 of long-term capital gains in the aggregate.

Accordingly, we believe that the forfeiture allocations rules should include an election that would allow partnerships to create offsetting notional tax items in the year of a forfeiture of a partnership interest, taking into account the character of the service provider's prior allocations. Just as the remedial allocation method eliminates distortions caused by the ceiling rule, we believe that partnerships should be allowed to elect to create offsetting notional tax items to eliminate distortions that may be caused (i) in the event the partnership does not have a sufficient amount of tax items in the year of forfeiture to offset prior allocations and (ii) in the even there is a character mismatch between the prior allocations and the tax items available in the year of forfeiture to make forfeiture allocations.

3. *Requiring all partners to agree (be bound) in writing to the liquidation value election safe harbor*

In order for the liquidation value safe harbor under the Proposed Regulations to apply to the transfer of a partnership interest for services, several requirements must be satisfied. One of the potentially applicable requirements is that each partner in the partnership execute a legally binding document stating that (i) the partnership is authorized and directed to elect the safe harbor and (ii) the partner agrees to comply with all requirements of the safe harbor with respect to all partnership interests transferred in connection with the performance of services while the election remains effective. Under the Proposed Regulations, this requirement will apply only if the partnership agreement does not already contain similar provisions. However, in cases where this requirement will apply, it has the potential to be overly burdensome and produce certain unintended consequences.

Many, perhaps most, partnerships have only a handful of partners. In these cases, the partners may decide to draft or amend (in the case of an existing partnership) their partnership agreement to include the required provisions. Even in cases where the partnership agreement is not drafted or amended to include the required provisions, it would be relatively easy, at least from an administrative standpoint, to

obtain an executed copy of a document containing the required provisions from each of the individual partners. However, some partnerships are very large. Specifically, pursuant to a safe harbor for private placements provided by the Treasury Regulations promulgated under section 7704, many entities may have as many as 100 owners and are classified as a partnership for federal income tax purposes. Moreover, even some entities with more than 100 owners are able to maintain their status as partnerships for federal income tax purposes. In these instances, obtaining an executed copy of a document containing the required provisions from each individual partner likely would be extremely burdensome.

In addition to creating a significant administrative burden, requiring each partner to consent to the safe harbor by executing a document containing the required provisions may have the added consequence of giving certain minority partners an unintended "bargaining chip" with respect to future partnership issues. Specifically, this requirement may allow individual partners with otherwise limited rights to hold the partnership and/or the rest of the partners "hostage" with respect to certain partnership decisions on which the minority partner would otherwise have no involvement under the terms of the applicable partnership agreement. Consequently, the other partners in the partnership could effectively be forced to give the minority partner preferential treatment and a "voice" on certain partnership issues simply to prevent the minority partners from doing anything that would prevent the partnership from electing to apply the safe harbor.

To avoid the problems and pitfalls identified above, we suggest that the Proposed Regulations be modified when they are promulgated as final regulations to allow the tax matters partner or the partners entitled to act on behalf of the partnership under applicable state law to elect to apply the safe harbor and bind the partnership and each of the partners with respect to the same.

4. *Presumption that a partnership interest is transferred in anticipation of a subsequent disposition when the interest is merely subject to rights to buy or sell*

The Notice generally provides that a partnership may elect to treat the liquidation value of a partnership interest transferred to a service provider in exchange for services as the fair market value of the interest. To qualify to make the election, however, the partnership interest must not be transferred to the service provider in anticipation of a subsequent disposition. In that regard, the Notice provides that, unless it is established by clear and convincing evidence that the interest was not transferred in anticipation of a subsequent disposition, a partnership interest will be presumed to have been transferred in anticipation of a subsequent disposition if the partnership interest is sold or disposed of within two years of the date of receipt of the partnership interest (other than a sale by death or disability of the service provider) or is subject, at any time within two years of the date of receipt, of a right to buy or sell regardless of when the right is exercisable (other than a right to buy or sell arising by reason of death or disability of the service provider).

We generally favor the provision of the Notice that a transfer of a partnership interest within two years of its receipt by the service provider will be presumed to have been transferred in anticipation of a subsequent disposition. We do not believe, however, that the mere right to buy or sell an interest transferred in exchange for services should operate as a presumption to remove an interest from the liquidation value safe harbor. The Committee is concerned that, in most all instances, the partnership interests received by the service provider will be subject to a "buy/sell" agreement. It is common to impose buy/sell agreements with respect to interests in closely held partnerships, particularly those issued to service providers. In those instances in which the service provider continues to perform services for the partnership, it is common that the service provider's partnership interest will be subject to a repurchase right if either the service provider voluntarily terminates his service with the partnership or the partnership terminates the service provider.

As currently drafted, the Notice will require partnerships to meet the clear and convincing standard to overcome the presumption even in instances where the partnership interest is transferred well after the two year period. This approach seems to place an unnecessary administrative burden on partnerships seeking to take advantage of the election. We recommend that if the final regulations contain an exception to the safe harbor provisions for interests that are acquired in anticipation of a subsequent disposition, that such exception be limited to those circumstances under which the partnership interest is, in fact, transferred within the applicable time period. Moreover, in those circumstances where an interest in a partnership is, in fact, transferred, the exception may be inappropriate, if the transfer is a result of the death, divorce or disability of the partner.

Finally, in community property states, the spouse of a service provider who receives a partnership interest in exchange for services of the holder may have ownership rights in the partnership. We assume the community property interest held by the spouse and service provider qualifies for the election. If so, the spouse's interest will be subject to a buy/sell agreement in the event of a divorce. The Notice excludes from the presumption sales or disposition by reason of the death or disability of the service provider. We suggest that the Notice be expanded to include the divorce or death of the spouse.

ENDNOTES

1 This report was prepared by members of the Partnership and Real Estate Tax Committee of the Section of Taxation of the State Bar of Texas. The principal drafters were the Chair of the Committee, James Howard, and the co-Vice Chairs of the Committee, Brandon Jones and Robert Phillpott. Helpful comments were received from a task force selected by the Section of Taxation to advise on this project, comprised of Mrs. Barbara de Marigny and Messrs. Bill Bowers, Bill Caudill, Brent Clifton, Chris Hanna, Tom Helfand and Kevin Thomason. The Committee on Government Submissions of the Section of Taxation of the State Bar of Texas, which consists of Ms. Emily Parker and Messrs. Vester Hughes, Steve Salch, Stanley Blend and Patrick O'Daniel, has approved this report.

2 References herein to "section" are to provisions of the Internal Revenue Code of 1986, as amended, unless otherwise indicated. Additionally, any reference to a "partnership" means any entity that is classified as a partnership for federal tax purposes under Treas. Regs. sec. 301.7701-3, and any reference to a "partner" means any person that holds an equity interest in an entity that is classified as a partnership under Treas. Regs. sec. 301.7701-3 and is treated as a "partner" of such entity for federal income tax purposes.

3 We recognize the possibility that this approach in certain circumstances may provide taxpayers an incentive to value partnership interests inappropriately low upon the issuance of interests in exchange for services, but we believe that a number of factors constrain this incentive. For example, in most compensatory situations, the historic partners will be entitled to a deduction equal to the amount of income included by the service provider, and thus, will have an incentive to increase the value of the partnership interests. Moreover, a number of statutory and judicial principles would limit the taxpayers' ability to value the partnership interests inappropriately, such as Code section 482 and the substance over form and assignment of income doctrines.

4 The Treasury Department and the IRS also requested comments as to whether section 83(b)(1) should be read to allow a forfeiting service partner to claim a loss with respect to partnership income that was previously allocated to the service provider and not offset by forfeiture allocations of loss and deduction, and if so, whether it is appropriate to require the other partners in the partnership to recognize income in the year of the forfeiture equal to the amount of the loss claimed by the service provider. If partnerships were able to create notional tax items in the event there were not enough tax items in the year of forfeiture, the service partner would always be allocated forfeiture allocations that would offset prior income allocations, and therefore, there would be no loss that could be disallowed under section 83(b)(1).

5 For purposes of determining a service provider's "net distribution," deemed cash contributions and distributions under section 752 are taken into account, a contribution or distribution of property is taken into account to the extent its adjusted tax basis, and distributions are taken into account to the extent such distribution is not taxable under section 731.

COMMENTS ON PROPOSED TREASURY REGULATIONS UNDER SECTION 409A

Editor's Note: The following comments were submitted to Treasury and the IRS on behalf of the Tax Section on December 30, 2005. The comments are reprinted here in their entirety.

These comments are presented on behalf of the Section of Taxation of the State Bar of Texas. The principal drafters of these comments were David C. D'Alessandro, Stephanie Schroepfer and Gene Wolf. James F. Carey, Donald O. Jansen and Gary Short provided helpful guidance in preparing and reviewing these comments. The Committee on Government Submissions (COGS) of the Section of Taxation of the State Bar of Texas has approved these comments. Patrick O'Daniel is Chair of COGS and the other members of COGS include Emily Parker, Vester Hughes, Steve Salch and Stanley Blend.

Although many of the people who participated in preparing, reviewing and approving these comments have clients who will be affected by the federal tax principles addressed by these comments and frequently advise clients on the application of such principles, none of the participants (or the firms or organizations to which such participants belong) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the subject matter of these comments.

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Date: December 30, 2005

I. EXECUTIVE SUMMARY

The following comments are submitted in response to a request for comments made by the Internal Revenue Service (the "*Service*") in notice of proposed rule making and notice of public hearing issued September 29, 2005, regarding section 409A ("*Section 409A*") of the Internal Revenue Code of 1986, as amended (the "*Code*"). The Service requested comments by January 3, 2006.

Following is a summary of our comments:

1. <u>Expansion of Broad-Based Foreign Retirement Plan Exemption for Persons Other Than U.S. Citizens or Green Card Holders</u>

We respectfully recommend that the exemption in the proposed regulations under Section 409A[1] (the "*Proposed Regulation*") for broad-based foreign retirement plans covering people who are not United States ("*U.S.*") citizens or green card holders be expanded by deleting the phrase "maintained by a person that is not a United States person." The exemption as written may not apply if the service provider's employer is a U.S. company as opposed to a foreign company. Section 409A is a service provider-centric rule, not a service recipient-centric rule. We propose that employees of U.S. companies be treated in the same manner as employees of foreign companies. The Proposed Regulation as drafted may encourage U.S. companies to outsource labor overseas. Our proposed expansion of the broad-based foreign retirement plan exemption would not apply to U.S. citizens or green card holders.

2. <u>Expansion of Permissible Pay-out Alternatives upon Service Provider's Separation from Service in Connection with a Change in Control</u>

We respectfully recommend that the Proposed Regulation be expanded to allow for alternative payment schedules if a Section 409A distribution event, separation from service, occurs in connection with a change in control event that satisfies Section 409A(a)(2)(A)(v) (a "*Change in Control*"). For example, we believe that a participant should be able to specify one form of distribution if a separation from service occurs in connection with a Change in Control and another form of distribution if the separation from service occurs absent a Change in Control. While the Proposed Regulation does provide some flexibility in specifying a different distribution form if a distribution occurs on or after a

specified date, the Proposed Regulation does not include this same flexibility in the case of a Change in Control. We recommend the Proposed Regulation be expanded in order to accommodate the standard compensation practice of providing for a lump sum payment where a separation from service is connected to a Change in Control. Such an alternative payment schedule would not increase the ability of a service provider to accelerate or otherwise control the timing of payment under a nonqualified deferred compensation plan (a "*NDCP*").[2]

3. Clarification of Right to Permit Automatic Lump Sum Payments

We respectfully recommend that the Proposed Regulation be clarified to grant to a plan sponsor the right to amend a NDCP to require that a service provider's entire interest in the NDCP be paid out in a lump sum if (i) that service provider's interest in the NDCP has a value below a specified dollar amount when those amounts are first payable, and (ii) that service provider does not have effective control over the plan sponsor or over any person who may amend the NDCP. As currently drafted, the Proposed Regulation is incongruous - it permits amendments to a NDCP to affect only *prospective* deferrals but requires that any distribution made pursuant to such an amendment be a distribution of the service provider's *entire* interest in that NDCP. Our recommendation is intended to remedy an inconsistency that appears to exist in the Proposed Regulation, while preventing manipulations of timing of payment by service providers.

4. Expansion of Right to Terminate and Liquidate Plans

We respectfully recommend that a plan sponsor be granted broad discretion to terminate and liquidate a NDCP with respect to any service provider other than a service provider who has effective control over the plan sponsor or over any person who may terminate the NDCP. We do not believe the Proposed Regulation sufficiently addresses the various legitimate, non-abusive circumstances under which it may be in a plan sponsor's best interest to terminate and liquidate a NDCP. Our recommendation provides an important extension to the Proposed Regulation while preventing manipulations of timing of payment by service providers.

II. BACKGROUND

Congress added Section 409A to the Code with the passage of the American Jobs Creation Act of 2004.[3] Section 409A significantly alters the taxation of income that is deferred under a NDCP after December 31, 2004. The Service issued initial guidance concerning Section 409A in the form of Notice 2005-1.[4] The Department of Treasury ("*Treasury*") and the Service issued additional guidance in the form of the Proposed Regulation.

III. COMMENTS

We commend Treasury and the Service for the time and thought that has been put into preparing the Proposed Regulation. We also appreciate the opportunity to comment on the Proposed Regulation and hope that our comments prove helpful.

A. BROAD-BASED FOREIGN RETIREMENT PLAN EXEMPTION FOR NONRESIDENT ALIENS AND CERTAIN RESIDENT ALIENS WHO DO NOT HOLD GREEN CARDS

1. Summary.

Section 1.409A-1(a)(3)(ii) of the Proposed Regulation provides the following exemption from Section 409A for nonresident aliens and persons who are resident aliens only because they have satisfied the substantial presence test of Section 7701(b)(1)(A)(ii) of the Code:

> (ii) Participation by nonresident aliens and certain resident aliens. With respect to an alien individual for a taxable year during which such individual is a nonresident alien or a resident alien classified as a resident alien solely under Section 7701(b)(1)(A)(ii) (and not Section 7701(b)(1)(A)(i)), the term non-qualified deferred compensation plan does not include any broad-based foreign retirement plan (within the meaning of paragraph (a)(3)(v) of this section) *maintained by a person that is not a United States person*. (Emphasis added.)

2. Recommendation.

We respectfully recommend that the proposed exemption for broad-based foreign retirement plans that do not cover U.S. citizens or green card holders be modified to make it clear that a participant will not be treated differently depending upon the identity of the service recipient. Specifically, we propose that the language in Section 1.409A-1(a)(3)(ii) of the Proposed Regulation be revised by deleting the words "maintained by a person that is not a United States person."

3. Explanation.

There appear to be different consequences under the Proposed Regulation depending upon whether the entity that is classified as the employer of the service provider is a U.S. person. Section 409A is a service provider centric rule designed to prevent manipulations of timing of income by service providers; it is not a service recipient centric rule.

For purposes of the exemption set forth in Proposed Regulation Section 1.409A-1(a)(3)(ii) what should really matter is the identity of the service provider, not the identity of service recipient. We respectfully propose that service providers not be treated differently under Section 409A merely because they are directly employed by a U.S. service recipient rather than a foreign company. The disparate treatment of service providers depending upon the identity of the service recipients would disadvantage U.S. service recipients by making them less attractive to work for than foreign entities.

The Proposed Regulation, as drafted, may encourage outsourcing by U.S. entities to foreign companies. Small and medium sized businesses, the largest sources of job growth in the U.S., may be at a relative competitive disadvantage under the Proposed Regulations if they directly employ

individuals rather indirectly retain the services of service providers employed by a foreign company.

When service providers perform services on short-term assignments in the U.S. typically (1) they are directly employed by a U.S. service recipient or (2) they remain employed by a foreign company and are "seconded" (in effect loaned) to the U.S. service recipient.

If a service provider is "seconded" to a U.S. service recipient by a foreign company the U.S. service recipient and a foreign company will typically enter into a chargeback arrangement under which the U.S. service recipient reimburses the foreign company for employment expenses, including foreign retirement plan contribution expenses, attributable to the service provider's service in the U.S. In such a case, since the U.S. service recipient does not have any contract with the service provider to pay the service provider retirement benefits, it appears that the U.S. service recipient does not "maintain" the broad-based foreign retirement plan (within the meaning of Section 1.409A-1(a)(3)(ii) of the Proposed Regulation).

If the service provider is not employed by a foreign company, but rather is directly employed by a U.S. service recipient while the service provider works in the U.S., and the U.S. service provider adopts and contributes to a broad-based foreign retirement plan on behalf of the service provider, the service provider may be subject to adverse tax consequences under Section 409A on the grounds that the broad-based foreign retirement plan is maintained by a U.S. person.

We note that many U.S. companies transfer employees of their overseas affiliates to the U.S. on short-term assignments. Frequently these employees are covered under broad-based foreign retirement plans. If the requested revision is not made to the Proposed Regulation exemption for broad-based foreign retirement plans some U.S. companies may be forced to redesign their broad-based foreign retirement plans to exclude from participation alien service providers who are rotating through the U.S. on short-term assignments. This would be an unfortunate result as in many cases it is important to transferring employees that they remain covered under the same broad-based foreign retirement plan while in the U.S. that they were covered under prior to their short-term assignments to the U.S.

We appreciate that the Department of Treasury is concerned about preventing potential abuses of offshore deferred compensation arrangements by U.S. citizens or green card holders. Our requested revision to Section 1.409A-1(a)(3)(ii) of the Proposed Regulation would not serve to benefit any U.S. citizens or green card holders.

B. <u>DIFFERENT PAYMENT SCHEDULES FOR SEPARATIONS FROM SERVICE DUE TO CHANGE IN CONTROL</u>

1. <u>Summary</u>.

Section 1.409A-3(c) of the Proposed Regulation establishes a general rule that if a NDCP provides that the payment of deferred amounts upon a permissible distribution event (other than upon a date certain) be made on a date certain or pursuant to a fixed schedule, then such date certain or fixed schedule must apply consistently regardless of when the permissible distribution event occurs.

Section 1.409A-3(c) of the Proposed Regulation provides an exception to this general rule by specifying that a NDCP arrangement may allow for not more than one alternative payment schedule following a permissible distribution event (other than a distribution on a date certain) if the permissible distribution event occurs on or before a specified date. Pursuant to the exception a NDCP may allow a service provider to elect a certain payment schedule if the distribution event occurs on or before a specified date, and to elect an altogether different payment schedule if such distribution event occurs after that specified date. Section 1.409A-3(c) of the Proposed Regulation offers the following example of this exception to the general rule:

> ... an arrangement may provide that a service provider will receive a lump sum payment of the service provider's entire benefit under the arrangement on the first day of the month following a separation from service before age 55, but will receive 5 substantially equal annual payments commencing on the first day of the month following a separation from service on or after age 55.

2. <u>Recommendation</u>.

We recognize that some limitation on the number of alternative payment schedules that a service provider may designate is necessary to effectuate the aim of Section 409A to prevent the manipulation by service providers of the timing of receipt of NDCP benefits. However, we recommend that the Proposed Regulation be expanded to allow for an alternative payment schedule if a service provider's separation from service occurs in connection with a Change in Control event that satisfies Section 409A(a)(2)(A)(v). Designating, or permitting a service provider to elect, an alternative payment schedule as a result of a service provider's separation from service in connection with a Change in Control would allow the service provider the flexibility to elect, for example alternative payment schedules upon each of: (a) separation from service on or before age 55; (b) separation from service after age 55; and (c) separation from service in connection with a Change in Control.

3. <u>Explanation</u>.

The Proposed Regulation unnecessarily limits the distribution options available to a service provider under a NDCP. Pursuant to the Proposed Regulation, if a NDCP gives a service provider the opportunity to timely elect a lump sum or installment payments upon a separation from service occurring other than in connection with a Change in Control, but specifies that a lump sum payment will be made upon a separation from service occurring in connection with a Change in Control, the arrangement would not comply with the Proposed Regulation distribution provisions.[5] When a service provider incurs a separation from service in connection with a Change in Control, a service provider generally would prefer payment in the form of a lump sum. Employment agreements and deferred compensation arrangements typically provide for lump sum payments of amounts owed to service providers upon their terminations of employment following a company's Change in Control. The Proposed Regulation fails to provide for this standard compensation practice.

Prior to Section 409A the time for income inclusion of nonqualified deferred compensation generally depended on

whether the arrangement was funded or unfunded (for purposes of constructive receipt and economic benefit principles). If the arrangement was funded, then the income was includible for the year in which the individual's rights were transferable or no longer subject to a substantial risk of forfeiture.[6] If the arrangement was unfunded, then income was includible in the year the amounts were actually or constructively received.[7] Accordingly, whether an arrangement provided for more than one alternative payment schedule depending on the date of, or event resulting in, distribution was generally irrelevant in determining the taxability of amounts deferred thereunder.

The Proposed Regulation is the first appearance of a rule limiting a service provider's ability to designate alternative specified payment schedules depending on the date of a permissible distribution event. There is nothing in Section 409A, the legislative history of Section 409A, or Notice 2005-1 that imposes or discusses imposing a similar limitation. The lack of mention of this issue prior to the issuance of the Proposed Regulation suggests that Congress did not perceive this practice as abusive. Thus, the Proposed Regulation imposes an unnecessary restrictive limitation that does not further Congress's purpose for enacting Section 409A.

We do recognize that reasonable limitations on the ability of a service provider to elect different payment forms due to the same Section 409A distribution event (such as separation from service) are necessary in order to prevent inappropriate manipulations of forms of payment by a service provider. For example, a service provider should not be able to specify that if a separation from service occurs on a Monday he will be paid in the form of a lump sum but if the separation from service occurs on a Tuesday he will be paid in the form of installments. The proposed revision to the Proposed Regulation would not give service providers an opportunity to inappropriately manipulate the form of payment of their NDCP benefits, but rather respects the typical contractual arrangement with respect to a Change in Control which Congress chose not to address.

C. AMENDMENT OF PLAN TO PERMIT AUTOMATIC LUMP SUM PAYMENTS

1. Summary.

Section 409A(a)(3) requires that a NDCP prohibit the acceleration of distributions, except as permitted in regulations issued by the Treasury. As currently drafted, one of the exceptions to the general rule prohibiting the acceleration of distributions under a NDCP is found in Section 1.409A-3(h)(2)(iv)(B) of the Proposed Regulation.[8] It states that a NDCP may provide, or be amended with regard to *future* deferrals to provide, that if a service provider's interest in the NDCP has a value below a dollar amount specified by the NDCP at the time that amounts are first payable under the NDCP, then the service provider's *entire* interest in the NDCP must be distributed as a lump sum payment.[9]

2. Recommendation.

We respectfully recommend that Section 1.409A-3(h)(2)(iv)(B) of the Proposed Regulation be modified to allow plan sponsors to amend NDCPs with regard to all deferrals - previously deferred amounts as well as amounts to be deferred in the future - for any service provider other than a service provider who: (i) has effective control of the plan sponsor; (ii) has effective control over any person within the plan sponsor who has discretion to amend the NDCP (such as an officer of a corporate plan sponsor); or (iii) is a member of the family (as defined in Section 267(c)(4), applied as if the family of an individual includes the spouse of any member of the family) of any person who has effective control of the plan sponsor or of any person within the plan sponsor who has discretion to amend the NDCP.

If Treasury does not amend Section 1.409A-3(h)(2)(iv)(B) of the Proposed Regulation in the manner recommended above, we encourage Treasury to at least remedy an internal inconsistency that currently exists in the regulation by replacing the second sentence in Section 1.409A-3(h)(2)(iv)(B) of the Proposed Regulation with the following two sentences:

> In addition, a nonqualified deferred compensation arrangement that otherwise complies with section 409A may provide that, if a service provider's interest under the arrangement has a value below an amount specified by the plan at the time that amounts are payable under the plan, then the service provider's entire interest under the plan must be distributed as a lump sum payment. Furthermore, a nonqualified deferred compensation arrangement that otherwise complies with section 409A may be amended with regard to future deferrals to provide that, if a service provider's post-amendment deferrals under the arrangement have a value below an amount specified by the plan at the time that amounts are payable under the plan, then the service provider's entire post-amendment deferral interest under the plan must be distributed as a lump sum payment.

3. Explanation.

The exception set forth in Section 1.409A-3(h)(2)(iv)(B) of the Proposed Regulation appears to be a rule of administrative convenience, permitting plan sponsors to accelerate plan benefits that become payable when those benefits have a value below a threshold amount established by the plan sponsor. The exception permits a plan sponsor to reduce the time and cost associated with administering the periodic payment of benefits over several years when the amount of those benefits does not warrant such time and cost. The exception should prove to be beneficial, especially to smaller plan sponsors that have limited internal resources. Furthermore, because the threshold established for the exception is established by the plan sponsor and requires a mandatory lump sum payment if the threshold is not exceeded, the exception is consistent with the Section 409A legislative goal of preventing manipulations of timing of payment by service providers.[10]

In its current form, the exception under Section 1.409A-3(h)(2)(iv)(B) of the Proposed Regulation creates a workable rule of administrative convenience only when it is incorporated into a newly created NDCP. However, for any NDCP that must be amended to incorporate the lump sum payout provision, the exception does not appear to be as clearly worded. First, there appears to be an inconsistency in the application of the exception to amended NDCPs. That is, the regulation currently states that an amendment to a NDCP can affect only prospective deferrals. The regulation then goes on to say, however, that if a lump sum distribution is required by virtue of the amendment, the service provider's

"entire" interest in the NDCP must be paid out in a lump sum - implying that both pre-amendment and post-amendment deferrals must be immediately distributed. This latter requirement is inconsistent with the premise that amendments can affect only prospective deferrals. Second, the regulation as currently written appears to impose on a plan sponsor that amends an existing NDCP a burdensome obligation to bifurcate benefits into pre-amendment benefits and post-amendment benefits. Keeping track of the bifurcated benefits would likely prove to be more difficult and burdensome for the plan sponsor than simply paying out plan benefits in accordance with their original schedule. For the reasons noted above, we believe that plan sponsors will not be willing to amend NDCPs in reliance on the currently worded exception under Section 1.409A-3(h)(2)(iv)(B).

We recommend that Section 1.409A-3(h)(2)(iv)(B) of the Proposed Regulation be modified to allow a plan sponsor to amend a NDCP with regard to previously deferred amounts as well as amounts to be deferred in the future. Modifying paragraph (h)(2)(iv)(B) of the Proposed Regulation in this manner will extend the exception's usefulness to existing NDCPs, while satisfying the Congressional requirement that permits benefits to be accelerated only upon an event that is beyond the control of a service provider. This modification would also remedy the inconsistency that currently exists in the regulation.

To ensure that a service provider's power to influence a plan sponsor to amend a NDCP is sufficiently limited in scope so as not to permit the manipulation of the timing of payments to the service provider, in our recommendation, we have proposed using an adapted version of the "facts and circumstances" effective control standard found under Section 1.409A-1(b)(1) of the Proposed Regulation.11 Both the Treasury Department and the Service have approved of this standard by including it in Section 1.409A-1(b)(1) of the Proposed Regulation. Our recommendation illustrates that this same concept of effective control can be easily extended to provide a plan sponsor broader discretion to amend a NDCP while at the same time adequately addressing the concern that the plan sponsor's discretion to amend a NDCP should not be exercised in a manner that would violate Section 409A's intent.

Alternatively, in the absence of amending Section 1.409A-3(h)(2)(iv)(B) of the Proposed Regulation in the manner recommended above, we encourage Treasury to remedy the internal inconsistency that currently exists in the provision.

D. PLAN TERMINATION AND LIQUIDATION

1. Summary.

Section 1.409A-3(h)(2)(viii) of the Proposed Regulation provides additional exceptions to the general rule under Section 409A(a)(3) prohibiting the acceleration of distributions under a NDCP. As currently drafted, Section 1.409A-3(h)(2)(viii) of the Proposed Regulation provides three circumstances under which a NDCP may be terminated and distributions accelerated at the discretion of the plan sponsor in accordance with the NDCP's terms. First, a NDCP may give the plan sponsor the discretion to terminate the NDCP upon a corporate dissolution subject to Section 331 or with the approval of a bankruptcy court pursuant to 11 U.S.C. §503(b)(1)(A), provided certain conditions are met. Second, a NDCP may give the plan sponsor the discretion to terminate a NDCP within the 30 days preceding or the 12 months following a change in control of event (as defined in Section 1.409A-2(g)(4)(i) of the Proposed Regulation), provided that the plan sponsor also terminates all substantially similar NDCPs provided by it. Finally, a NDCP may give the plan sponsor the discretion to terminate all NDCPs of the same type (account balance plans, nonaccount balance plans, separation pay plans or other arrangements) with respect to all participants, again provided certain conditions are met.

2. Recommendation.

We respectfully recommend that another permissible termination event be added to Section 1.409A-3(h)(2)(viii) of the Proposed Regulation to give a plan sponsor broad discretion to terminate a NDCP with respect to any service provider other than a service provider who: (i) has effective control of the plan sponsor; (ii) has effective control over any person within the plan sponsor who has discretion to terminate the NDCP (such as an officer of a corporate plan sponsor); or (iii) is a member of the family (as defined in Section 267(c)(4), applied as if the family of an individual includes the spouse of any member of the family) of any person who has effective control of the plan sponsor or of any person within the plan sponsor who has discretion to terminate the NDCP.

3. Explanation.

None can forecast the variety of legitimate, non-abusive reasons a plan sponsor may have to terminate a NDCP. As such, plan sponsors need sufficient flexibility associated with terminating NDCPs on a plan by plan, service provider by service provider basis. For example, plan sponsors will from time to time implement NDCPs that do not perform or function as intended or represented. In that case, plan sponsors should have a mechanism for terminating each underperforming NDCP without being required to terminate every NDCP that would be aggregated with that underperforming NDCP. Accordingly, we do not believe the three circumstances currently provided under Section 1.409A-3(h)(2)(viii) of the Proposed Regulation sufficiently address the various legitimate, non-abusive circumstances under which it may be in a plan sponsor's best interest to terminate a NDCP. We are aware that in drafting Section 1.409A-3(h)(2)(viii) of the Proposed Regulation, Treasury and the Service were concerned with potential abuses associated with granting plan sponsors a broad power to terminate NDCPs, which would cause the acceleration of distributions. However, employing such a restrictive view on a plan sponsor's power to terminate a NDCP for reasons beyond the direct or indirect control of the service provider appears to be inconsistent with Section 409A's true intent.

The legislative history behind the enactment of the rule prohibiting acceleration of distributions clearly indicates that Congress was primarily concerned about the perceived abuse of NDCPs that allow service providers inappropriate levels of control over or access to amounts deferred.12 Toward that end, Congress expressly intended that exceptions to the general prohibition on acceleration of payments from NDCPs would be provided "only in limited cases where the accelerated distribution is required for reasons beyond the control of the participant."[13] Thus, from a federal tax law perspective, Congress's underlying goal behind prohibiting the acceleration of distributions appears to have been to prevent tax deferral abuses resulting from the service provider's ability to arbitrarily choose when to receive the deferred income and, accordingly, when to pay the associated tax. With respect to service providers, such a goal

converges with longstanding compensation recognition doctrines such as the constructive receipt doctrine, which provides that a cash basis service provider is required to recognize income when (i) the service provider's right to the income is not restricted; (ii) the plan sponsor is able and ready to pay the service provider; and (iii) the delay in receipt of payment is attributable to the service provider's choice.[14] Hence, if at a certain point in time a service provider is able to choose at his discretion when to receive the deferred income from a NDCP, the service provider should, at the time he acquires that discretion, become liable for the tax associated with such constructively received income.

But Congress did not extend to plan sponsors the same broad concerns Congress had with service providers with respect to the power to accelerate distributions. We appreciate the concern expressed by Treasury and the Service in the preamble to the Proposed Regulation regarding the potential for abuse by granting plan sponsors a broad power to terminate NDCPs with respect to an individual service provider when that service provider either directly or indirectly has effective control over the plan sponsor to cause the plan sponsor to terminate a NDCP. But, when considering Congress's underlying goal to prevent tax deferral abuses resulting from the service provider's ability to arbitrarily choose when to receive the deferred income, we do not believe that such a concern is warranted when a service provider lacks effective control over the plan sponsor and, therefore, cannot exercise influence over the plan sponsor to cause the termination of a NDCP in order to accelerate distributions. In that case, any termination of a NDCP by a plan sponsor would be for reasons beyond the service provider's control, which falls within Congress's intended exceptions to the prohibition on acceleration of distributions. This result is also consistent under the longstanding compensation recognition doctrines such as the constructive receipt doctrine because such a service provider is at the mercy of the plan sponsor with respect to when deferred amounts are to be received and, accordingly, would not obtain the right to receive the deferred income until the plan sponsor terminates the NDCP.

To ensure that a service provider's power to influence a plan sponsor to terminate a NDCP in which he is a participant is sufficiently limited in scope so as not to permit that service provider to manipulate the timing of this payments, in our recommendation, we have proposed using an adapted version of the "facts and circumstances" effective control standard found under Section 1.409A-1(b)(1) of the Proposed Regulation.[15] Both Treasury and the Service have approved of this standard by including it in Section 1.409A-1(b)(1) of the Proposed Regulation. Our recommendation illustrates that this same concept of effective control can be easily extended to provide a plan sponsor broader discretion to terminate a NDCP while at the same time adequately addressing the concern that the plan sponsor's discretion to terminate a NDCP should not be exercised in a manner that would violate Section 409A's intent.

If this proposal is unacceptable to Treasury and the Service, then our recommendation could be further limited by prohibiting the service provider[16] from being enrolled[17] for a period of five years following the date of termination as a new participant in any NDCP that would have been aggregated (within the scope of Section 1.409A-1(c) of the Proposed Regulation) with the terminated NDCP. This rule is an adapted version of the limitation found under Section 1.409A-3(h)(viii)(C)(4) of the Proposed Regulation.[18]

ENDNOTES

1 The Service issued REG-158080-04, which contains Prop. Reg. §§ 1.409A-1 through 1.409A-6, on September 29, 2005. REG-158080-04 was published in the Federal Register on October 4, 2005. 70 Fed. Reg. 57,930 (Oct. 4, 2005). The effective date of the Proposed Regulation is January 1, 2007.

2 A NDCP is any plan, agreement or arrangement subject to IRC § 409A that provides for the deferral of compensation from one year to another.

3 Pub. L. No. 108-357 (codified in scattered sections of 26 U.S.C.).

4 Notice 2005-1 was originally issued on December 20, 2004. It was clarified and republished in Internal Revenue Bulletin 2005-2 on January 10, 2005.

5 Of course, the arrangement could provide for payment on account of the occurrence of a change in control (within the meaning of Section 409A) without regard to the service provider's separation from service and still comply with Section 409A. However, this limits the flexibility of the service recipient to delay payment in those cases where the service provider will continue to provide services after the change in control and therefore may not have a need for, or a desire to receive, payment of the nonqualified deferred compensation at issue.

6 *See* IRC § 83(a).

7 *See Basila v. Comm'r*, 36 T.C. 111, 115-16 (1961); Treas. Reg. § 1.451-2(a).

8 Prop. Reg. § 1.409A-3(h)(2)(iv) sets forth two exceptions to the general rule prohibiting the acceleration of distributions under a nonqualified deferred compensation plan. The first such exception, found under Prop. Reg. § 1.409A-3(h)(2)(iv)(A), provides that a plan which does not permit the lump sum payment of benefits that are below a specified dollar amount may be amended to permit the acceleration of the payment if certain requirements are satisfied, including the requirement that the payment not be in excess of $10,000. The amendment permitted under paragraph (h)(2)(iv)(A) may be made with respect to previously deferred amounts as well as amounts to be deferred in the future. The exception set forth under paragraph (h)(2)(iv)(A) is not the subject matter of this recommendation. Instead, the subject matter of this recommendation is contained in paragraph (h)(2)(iv)(B).

9 *See* Prop. Reg. § 1.409A-3(h)(2)(iv)(B).

10 In lieu of simply prohibiting every type of acceleration, Congress intended for Treasury to provide limited "exceptions to the prohibition on accelerated distributions, such as when the accelerated distribution is required for reasons beyond the control of the participant and the distribution is not elective." See H.R. Conf. Rep. No. 108-755, at 731 (2004).

11 This effective control standard relates to the situation in which a plan sponsor's discretion to reduce or eliminate a service provider's compensation will not be treated as having substantive significance for purposes of determining whether a service provider has a legally binding right to compensation.

12 *See* H.R. Rep. No. 108-548, at 343 (2004).

13 *Id.* at 345; *accord* H.R. Conf. Rep. No. 108-755, at 731 (2004).

14 *See Basila v. Comm'r*, 36 T.C. 111, 115-16 (1961). Section 1.451-2(a) of the regulations describes the constructive receipt doctrine as follows:

Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year

during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. Thus, if a corporation credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt.

15 *See supra* note 11. Note that under our recommendation if a NDCP plan has as one of its participants a service provider who has the ability to influence a plan sponsor to terminate that NDCP, then that NDCP may be terminated with respect to all other service providers except for the service provider who has such influence.

16 Note that this proposed limitation imposes a restriction on the basis of the identity of the service provider and not the identity of the service recipient or the plan sponsor.

17 Note that this proposed limitation does not require the service provider to terminate participation in every NDCP of the same type (account balance plans, nonaccount balance plans, separation pay plans or other arrangements). Instead, it prevents that service provider from enrolling in a NDCP of the same type.

18 Prop. Reg. § 1.409A-3(h)(viii)(C)(4) prevents a service recipient from adopting a new NDCP of the same type of NDCP (account balance plans, nonaccount balance plans, separation pay plans or other arrangements) that it terminated in accordance with the provisions of Prop. Reg. § 1.409A-3(h)(viii)(C).

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