THE TEXAS TAX LAWYER

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CHAIR'S MESSAGE

As you read this Chair's Message, the Section's leadership is preparing for the Annual Meeting in San Antonio on Friday, June 25, beginning at 10:00 a.m. It is no understatement that we are a Section at the crossroads.

As I explained in my first Chair's Message in the October, 2003 addition of the Texas Tax Lawyer, our Annual Meeting on Friday the 13th of June, 2003 was marked by a group of Section members nominating each other for the officer and council member positions that were open – a takeover attempt that came within one vote of succeeding, due to no notice of their intentions and some bad weather in Dallas that had prevented a number of Section members from making it to Houston. It was noteworthy that the person nominated for Chair-Elect by this group freely admitted that he had never participated in any Section activities previously – much less occupied leadership positions.

Since discussions with many Section members over the course of last summer indicated that virtually all of them felt it to be unwise that Section leadership be determined at the Annual Meeting without any opportunity beforehand to know who was running and what their backgrounds might be, a Task Force was commissioned to study revision of the Bylaws in general, and changes to the election process in particular. The majority recommendation of that Task Force, a concurring recommendation, and a dissenting recommendation, are included in this edition of the Texas Tax Lawyer, and I heartily recommend your study of the Task Force report. The Section's Council has recommended adoption of the changes found in the majority recommendation of the Task Force. Under the procedures laid out in the majority recommendation, all those who wish to run for election to Officer or Council positions would be allowed to do so, following notification of that fact prior to the Annual Meeting – this would allow for publication and dissemination of their names to the entire Section membership long before the election. The result would be an orderly and thoughtful process that would culminate in the Section making a fully informed decision on each position up for election.

So, our Section finds itself at the crossroads – the Section will decide not only on whether new procedures will be followed for future elections; it will also – under the old Bylaws – elect its leadership based not only on recommendations by this year's Nominating Committee, but also on any floor nominations.

This year's Nominating Committee included three past chairs of the Section: Brent Clifton, Willie Hornberger, and Cindy Ohlenforst. The Nominating Committee has made the following nominations:

POSITION	**NAME**
Chair-Elect	William P. Bowers
Secretary	Gene Wolf
Treasurer	Kevin Thomason
Council Member (term expiring 2007)	Elizabeth Copeland
Council Member (term expiring 2007	Walt McCool
Council Member (term expiring 2007)	Christina Mondrik

Pursuant to the Section's Bylaws, David Wheat will succeed to the position of Chair, from his current position as Chair-Elect.

Our Section's Council and Committee Chairs/Vice Chairs continue to make progress on our goals for this year, most recently completing the appointment of delegates to IRS councils; completing an outline designed to help committee chairs provide enhanced benefits for committee membership and encourage member involvement; beginning our work with Texas C-Bar; providing preliminary reports on enhancing participation between the Section and tax programs at Texas law schools; completing a final report outlining how to ensure that small firm practitioners are incorporated in Section management/activities; and beginning our support for, and assistance to, the Justice for All Calendar sponsored by the State Bar.

I look forward to seeing everyone at our Annual Meeting in San Antonio on Friday, June 25.

Jasper G. ("Jack") Taylor III
Chair, Section of Taxation
State Bar of Texas

NOTICE OF ANNUAL MEETING

The Council Members and Officers

of the State Bar of Texas Tax Section

cordially invite

the Members of the Tax Section

to attend the Section's Annual Meeting

to be held at the

Marriott Riverwalk Hotel
711 East Riverwalk
San Antonio, Texas 78205
(210) 224-4555

on

Friday, June 25, 2004 from 10:00 a.m. to 11:30 a.m.

with lunch to follow at 12:00 noon.

Agenda items will include the Members' election of officers and three council members and vote on amendments to the ByLaws.

OUTSTANDING TEXAS TAX LAWYER AWARD

The Council of the Section of Taxation will be awarding this year the second annual "Outstanding Texas Tax Lawyer" award. To be qualified, a nominee 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. "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; and "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. 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.

The award will be made at the 2004 Advanced Tax Law course in September, so any nominations should be submitted on the following form to R. David Wheat, either by email (david.wheat@tklaw.com) or hardcopy (fax number 214-880-3181) no later than June 30, 2004.

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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SECTION OF TAXATION OF THE STATE BAR OF TEXAS

2003-2004 CALENDAR

July	
11	New Chair/Treasurer Orientation, Texas Law Center - Austin
15	Quarterly dues check mailed to section treasurers
August	
1-2	Local Bar Leaders Conference, Omni Mandalay, Las Colinas
10	Texas Bar Foundation grant application deadline
13	Deadline for submitting articles for the October 2003 issue of the newsletter
September	
1	Inform State Bar of section's Annual Meeting program chair
12	Council of Chairs meeting, Austin
21	State Bar of Texas CLE 21st Advanced Tax Law Course (co-sponsored by the Section of Taxation) in Dallas, Texas. For more information, visit www.TexasBarCLE.Com click on "Courses" and search Practice Areas for "Tax"
26	10:00 a.m. - 12:00 p.m. Council/Committee Chairs Meeting **MANDATORY IN PERSON ATTENDANCE BY ALL COUNCIL MEMBERS AND EITHER CHAIR OR VICE CHAIR** Fulbright & Jaworski L.L.P. 1301 McKinney, Suite 5100 Houston, Texas 77010-3095 713-651-5100
October	
3	SBOT section program chair: Select program and proposed speakers for SBOT Annual Meeting 2004
15	Quarterly dues check mailed to section treasurer

November	
14	10:00 a.m. - 12:00 p.m. Council/Committee Chairs Meeting Fulbright & Jaworski L.L.P. 1301 McKinney, Suite 5100 Houston, Texas 77010-3095 713-651-5100
December	
10	Deadline for submitting articles for the February 2004 issue of the newsletter
12	Prepare section mid-year report (due Jan. 1)
January	
15	Quarterly dues check mailed to section treasurer
16	Council of Chairs meeting, Austin
16	10:00 a.m. - 12:00 p.m. Council/Committee Chairs Meeting **MANDATORY IN PERSON ATTENDANCE BY ALL COUNCIL MEMBERS AND EITHER CHAIR OR VICE CHAIR** Fulbright & Jaworski L.L.P. 1301 McKinney, Suite 5100 Houston, Texas 77010-3095 713-651-5100
29-31	ABA section of taxation Midyear Meeting, Kissiminee, Florida
February	
6	Send information to State Bar for promotional section flyers and annual meeting registration form
March	
11	Deadline for submitting articles for the May 2004 issue of the newsletter
12	10:00 a.m. - 12:00 p.m. Council/Committee Chairs Meeting Fulbright & Jaworski L.L.P. 1301 McKinney, Suite 5100 Houston, Texas 77010-3095 713-651-5100
31	Property Tax Committee Annual Seminar, Austin, Texas

April	
1	Deadline for SBOT Annual Meeting resolutions
9	Council of Chairs Meets - TLC, Austin
15	Quarterly dues check mailed to section treasurer
May	
6-8	ABA Section of Taxation May Meeting, Washington, D.C.
7	Prepare section end-of-the year report for publication in July Bar Journal
14	10:00 a.m. - 12:00 p.m. Council/Committee Chairs Meeting Fulbright & Jaworski L.L.P. 1301 McKinney, Suite 5100 Houston, Texas 77010-3095 713-651-5100
June	
17-18	Texas Federal Tax Institute
24-25	SBOT Annual Meeting, San Antonio
25	10:00 a.m. – 12:00 p.m. Annual Meeting/Council Meeting Mariott Riverwalk Hotel San Antonio, Texas

20th Annual

Texas Federal Tax Institute

"The Best Advanced Program Between the Coasts"

June 17 and 18, 2004

Hyatt Hill Country Resort
San Antonio, Texas

Two Days of the Highest Quality CLE on Advanced Federal Partnership, Real Estate and Corporate Tax Topics

SCHEDULED TOPICS AND SPEAKERS:

Current Issues in Tax-Free Reorganizations – Karen Gilbreath
Tax Accounting Issues in Corporate Transactions – Glen Carrington
Corporate Tax Shelter Update – Robert Rizzi
Tax Issues for Insolvent and Financially Troubled Corporations – Philip Wright and William Alexander (IRS)
Consolidated Returns Update – Gordon Warnke
Tax-free Spin-offs – Peter Canellos
Current Developments in Partnership and Real Estate Taxation – William H. Caudill and Nicholas J. DeNovio
Joint Ventures with Tax-Exempt Entities – Paul H. Asofsky
Tenants-in-Common: Tax, Securities, Lending and Business Issues – Louis S. Weller and Anthony W. Thompson
REIT Basics – C. Ronald Kalteyer and David M. Dean
Special Drafting Issues – William P. Bowers and R. Brent Clifton

FEATURED LUNCH SPEAKERS:

Pamela F. Olson, Former Assistant Secretary of Treasury (Tax Policy)
Vester T. Hughes, Jr.

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WORLD CLASS GOLF/RAMBLIN' RIVER
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The Partnership and Real Estate Tax and Corporate Tax Committees of the Tax Section of the State Bar of Texas
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Call Texas Institute of CLE for more information
512/451-6960

FINAL REPORT OF THE BYLAWS REVIEW TASK FORCE

(Messrs., Bill Bowers, Rhett Buck, Allen Craig, Robert Gibson and Kevin Thomason)

Introduction:

This Task Force was appointed by the Council for the purpose of reviewing the Bylaws of the Section and proposing changes thereto:

- in the administrative procedures of the Section (such changes are hereinafter referred to collectively as the "Administrative Changes"); and

- in the nomination and election procedures for Council members and the offices of Chair-Elect, Secretary and Treasurer (such changes are hereinafter referred to collectively as the "Nomination and Election Changes").

Following due deliberation and presentation to the Council of its preliminary report, the Task Force recommends the changes noted below to the Bylaws. The Task Force members unanimously support the Administrative Changes. These changes promote operational efficiency within the Section and, in certain instances, conform the Bylaws with planned administrative changes. A majority of the Task Force members recommend the Council adopt the Nomination and Election Changes. The Task Force's reasons for these changes are explained in the section entitled "Majority Report". Separate minority and concurring reports are included herein. A copy of the Bylaws, marked to show these changes, is attached.

I. **Administrative Changes.**

1. Current: Under Section 1.2, an objective of the Section is to promote legislation and administrative rulings affecting federal and state tax laws.

   Change: The purpose clause is revised to conform to the State Bar of Texas' rules limiting the promotion of legislation and administrative rulings and regulations.

2. Current: Section 2.1 provides for annual membership dues of $25.

   Change: The Council is given the authority to set annual dues. Additionally, dues are required to be paid in advance, and the membership of any member delinquent in payment by more than six months will be terminated.

3. Current: Section 3.5 provides for the removal of Council members in certain instances.

   Change: The removal process is expanded to cover Officers as well as Council members.

4. Current: Section 5.3 includes as a duty of the Secretary the preparation of a summary or digest of proceedings of the Section at its annual meeting.

   Change: The preparation of the summary or digest is duplicative of the minutes of Section's annual meeting, and accordingly, the Secretary's duties are revised to eliminate the preparation of this summary or digest.

5. Current: Section 6.1 refers to certain governing documents of the State Bar and Section offices.

   Change: The document and office names are changed to reflect their current titles.

6. Current: Section 6.2 lists the Section's standing committees.

   Change: The names for certain committees are changed to reflect current usage. Additionally, the list of standing committees is expanded to include the newly created Solo Practitioner and Small Firm Committee.

7. Current: Section 6.4 sets the quorum requirements for Council meetings.

   Change: Council members participating in telephonic meetings are counted in determining the members present for purposes of the quorum requirement.

8. Current: Section 6.5 provides voting procedures for Council meetings.

   Change: Council members participating in a telephonic meeting may vote.

9. Current: Section 7.2 provides the procedures for calling a special meetings of the Section.

   Change: A special Section meeting may be called only with ten days notice (either written or by electronic mail) to all Section members.

10. Current: Section 7.4 provides that a special meeting of the Council may be called only with ten days written notice thereof to each Council member.

    Change: Notice to Council members of a special meeting may be given by either electronic mail or written notice.

11. Current: Section 8.3 provides Section reimbursement procedures for those attending Council meetings or otherwise engaging in Section operations.

    Change: It is made explicit that reimbursement procedures are subject to applicable requirements of the State Bar.

Task Force Recommendation Regarding Administrative Changes: The members of the Task Force unanimously recommend the adoption of these changes.

II. **Nomination and Election Changes:** Set forth below is a summary of the pertinent provisions of the current Bylaws and the proposed changes thereto.

Current: Section 4.1 provides that the Chair shall preside over and appoint a Nominating Committee that reports nominations to the Section for the offices of Chair-Elect, Secretary, Treasurer and three Council positions. The Nominating Committee shall consists of at least three members, none of which are current Council members. The Nominating Committee must be selected at least sixty days prior to the Section's Annual Meeting. The Nominating Committee's report is published in The Texas Tax Lawyer at least thirty days prior to the annual meeting. At the annual meeting, nominations for the offices are accepted from the floor. Section 4.2 provides that elections for the Council and Officer positions are held at the annual meeting.

Change: The procedures regarding the selection of the Nominating Committee are modified to provide that the Chair is now an *ex officio* member of the Nominating Committee, and the Nominating Committee will be appointed within thirty days of the beginning of the Section's fiscal year. Also, the procedures will require that the first edition of *The Texas Tax Lawyer* issued after the annual meeting identify the members of the Nominating Committee and solicit from the Section candidates for the offices of Chair-Elect, Secretary, Treasurer and three Council positions. A candidate questionnaire will be required to be completed by any person nominated for a position. From those that submit candidate questionnaires, the Nominating Committee will select its nominees and will report its slate at the Council's last meeting prior to the Section's Annual Meeting. At such meeting, the Council shall elect the Chair-Elect, Secretary and Treasurer. The Nominating Committee's nominees for the three Council positions together with all other candidates completing a candidate questionnaire will be identified as candidates for such positions in last issue of *The Texas Tax Lawyer* published prior to the Section's annual meeting. All candidates listed in the publication for the Council positions will stand for election at the annual meeting. No floor nominations will be allowed at the annual meeting.

Task Force Recommendations Regarding Nomination and Election Changes: A majority of the Task Force recommends the adoption of these changes

III. **Majority Report - Bill Bowers, Robert Gibson and Kevin Thomason**

A majority of the Task Force recommends adoption by the Council and then approval by the Tax Section membership of the changes described above. The reasons for this recommendation are explained below.

The current Bylaws provide for election, by the members in attendance at the Section's Annual Meeting, of the Section's Officers (other than the Chair, who automatically succeeds to that office from his or her term as Chair-Elect) and of the three new members who are added to the Council every year. This regime has structural weakness: (1) the eligible voters—being all of the members of the Section—have almost no way of obtaining knowledge about the credentials of the potential nominees, their service to the Section or their enthusiasm for serving as Section leaders, and (2) with no quorum requirement at the Annual Meeting, and with the Annual Meetings being held at geographically diverse (and, given the dimensions of Texas, geographically distant) locations, the results of such elections truly can be, and are, determined by a very small portion of our membership.

Given those obvious structural weaknesses in our formal regime, the Section evolved an informal approach that worked very well for many years. A three-member Nominating Committee (which excludes existing Council members per the Bylaws and therefore has generally been staffed with persons who have completed some years of service to the Section--often ex-Chairs of the Section) made nominations for the open Officer and Council positions, having had significant opportunity to observe the performance of the members then serving as Officers, Council members and Committee Chairs. After gathering information on potential nominees, they would nominate (a) a slate of new Council members generally drawn from the most talented and deserving of the Committee Chairs, (b) a Treasurer from among the Council members whose terms were expiring, with performance as a Council member being the major determinant of who was so nominated, and (c) absent some failure of performance or request not to be nominated, the incumbent Treasurer as Secretary and the incumbent Secretary as Chair-Elect. These nominees were regularly elected by acclamation at sparsely attended Annual Meetings. Thus, by informally layering this tradition of merit selection on top of the formal provisions of our Bylaws, a steady succession of excellent, dedicated and experienced Section members rose through the Committee Chair, Council and Officer positions, a tradition that has led to the superior performance and stability of the Section's leadership—and thus the Section—for decades.

Last June, a small group of members attempted to circumvent these traditions and elect, per the letter of the Bylaws, a slate of Officers and new Council members, none of whom had served the Section in any leadership capacity. Ultimately the slate presented by the Nominating Committee was elected, with one disappointing exception of a person whom the Nominating Committee had nominated for one of the open Council positions and who had served the Section for several years in a number of important capacities.

We inform you of this phenomenon not to criticize the motives of those who engineered this outcome. However, we do believe that the informal tradition, which produced qualified and dedicated members with significant prior service to the Section, now needs to be formalized to avoid any future exploitation of the identified weaknesses in our Bylaws. The arguments for so doing are simple, but we believe compelling.

Regarding Officer nominations and elections: We recommend (x) that all nominations be made to the Nominating Committee in time to allow it to investigate the qualifications, history of service to the Section and willingness to serve of the nominees and to make its recommendations for the three open Officer positions prior to the last Council meeting of the Section year, and (y) that the Council choose from among such nominees, taking into account the recommendations of the Nominating Committee, in filling the three open Officer positions. Notice that this proposal allows any member to nominate any other member for any open Officer position, quite an improvement over the narrow nomination avenues presently available (either nomination by the Nominating Committee or attendance at the Annual Meeting), and provides a fairly potent response to those who would label as exclusionary the proposed process.

As for placing the selection of the new Officers in the hands of the Council: This process should be very familiar and happily preferred by our membership, inasmuch as it is precisely analogous to that used by our corporate clients to elect their officers. The Boards of Directors of both "for-profit" and "not-for-profit" corporations elect their officers for the obvious reason that such Boards—like our Council—are in the best position to observe the performance of those who would seek election as officers. The approach we are proposing works well in the private sector, and we believe it will work well for the Section.

Regarding Council nominations and elections: We recommend that all nominations for the three annually elected Council positions be submitted to the Nominating Committee sufficiently in advance of the Annual Meeting so as to allow it to (i) identify who such nominees will be, (ii) confirm the desire of a nominee to serve and collect information on such nominee for its use in making its recommendations, and (iii) disseminate in the Texas Tax Lawyer prior to the Annual Meeting the names of those standing for election and of the nominees recommended for election by such Nominating Committee. Again, the process is entirely open, merely eliminating the ability, via floor nominations, to nominate and elect candidates that have not been identified to the membership prior to the Annual Meeting. The advantages of such a process would seem to be obvious. What it does exclude is floor nominations at the Annual Meeting, which simply means that a nominee must be identified, scrutinized and consulted well before the voting of the members in attendance at an Annual Meeting.

In conclusion, we would remind the members that the informal selection traditions which we are recommending be formalized have served the Section very well for a long time. Notwithstanding recent intimations to the contrary, all voices in the Section are heard and valued, and every member who wishes to serve the Section is welcome to do so. All members of the Section, whether from large or small firms, who have been willing to work their way up in the Section have held every leadership role available in the Section. We recommend to the Section these proposed changes without reservation.

IV. **Minority Report - Rhett Buck**

Two controversial Bylaws changes have been proposed by the Board of Council. These Bylaw changes are designed to insulate the Tax Section leadership from direct election by members. The Bylaw changes, if approved by the members, will prevent members from making floor nominations for leadership positions, and prevent members from electing officers. Nominations will have to be submitted and published in advance, and officers will be elected by the Board of Council.

As some members are aware, discontent among solo and small firm tax attorneys about Tax Section policies and priorities regarding CLE content and pricing, and some other issues, sparked, for the first time in the remembered history of the Tax Section, floor nominations and contested elections for all open leadership positions.

The Board of Council has recently taken some steps to address the concerns of solo and small firm tax attorneys, but has focused most of its attention on changing the Bylaws to make it more difficult for such members to elect officials more responsive to their concerns. Current leadership fears that solo and small firm tax attorneys, out of real or imagined concern that their needs are not being met, will attend the next or a subsequent annual meeting en masse, and foolishly nominate and elect new leaders who may be so inexperienced and incompetent that the efficient and orderly functioning of the Tax Section will be disrupted.

However, the decision to change our Bylaws belongs to the members, not the Board. You may vote yes or no at the next annual meeting, for new Bylaws that will limit the ability of members to nominate and elect their own leaders. However, for such an important matter, your decision should not be based merely on the issue at hand. The reason to change the Bylaws should not be merely because you are concerned that solo tax attorneys, or small firm tax attorneys, or, if the shoe were on the other foot, large firm tax attorneys, may band together and vote in their own interest. All of us have always been able to, and on various occasions have, voted similarly on issues on concern to members, whether it be CLE content, dues, charitable endeavors, minority participation, attorney trust funds, etc., etc. Our Bylaws were purposefully designed to provide a political process of election of leaders by members to ensure that our section leadership promotes policies of importance to the members. The question should be: do you want to provide for a new method of appointing leaders that ensures that our leaders are less accountable to members, on any particular issue that may arise?

There are some good arguments that can be made that limiting the ability of members to elect their leaders will result in a more efficient, orderly and well-trained leadership. It is not my job to present those arguments. I am the only floor-nominated, elected tax section official, ever. I was the only one on the Bylaws committee to vote against the proposed Bylaw changes, and may be the only Council Member to vote against the Bylaw changes. By actual circumstance, I do in fact represent the free right of members to nominate and elect their own officials and therefore it is my beholden duty to urge you to consider voting against the proposed Bylaw changes. And I further urge you to consider the best interests of all Texas tax attorneys, not just your own self-interest. Is this current issue of such weight and controversy, and are there any other controversial issues that may arise in the next century, that may have such controversy, that we should want to insulate our leaders from their immediate concern and attention? You should also consider that the power of members to freely nominate and elect their officers, once given away, may never be returned.

V. **Concurring Report - Allen B. Craig**

For the reasons addressed in this report, I have chosen to prepare a concurrent report. I believe that the proposed Amendments are procedural in nature and the reasons for and against the Amendments should be more clearly presented to the Membership, as follows:

1. Reasons in support of the Amendments

   A. Elimination of floor nominations for election of Council Members;

      i. Opportunity for dissemination of credentials of candidates; Adoption of the proposed Amendments will permit the full credentials of each candidate to be distributed well in advance to each member of the Section.

      ii. No impairment of right of election by members at meeting; Election will continue to be made by the members attending the annual meeting.

      iii. No limitation on nominees; Any individual who is timely nominated and whose credentials have been distributed to the membership will be included in the ballot voted on at the annual meeting.

iv. Preservation of Nominating Committee recommended slate; The Amendment continues to provide for a Nominating Committee which will make its own judgments as to comparative credentials of the nominees submitted. The Nominating Committee should take into consideration the credentials of each nominee, the past service of each nominee, and all other relevant factors in selecting the recommended slate. Notwithstanding the recommendation of the Nominating Committee, the membership is reserved the right to elect all of the slate, none of the slate or some of the slate.

v. More efficient annual meetings. The elimination of floor nominations will eliminate the need for extended presentation of newly nominated candidates and their credentials. Presentations by each candidate can be shortened to the extent individual nominee platforms or agenda are previously distributed to the voting members.

B. Election of Officers by Council

i. Council is duly elected representatives of membership; The Council is a representative body and should be representative of the entire membership. Voting for officers should be based upon that representative duty.

ii. Publication of credentials of nominees permits members to contact the Council with comments; As a representative body, Council is prepared to receive comments from any member with recommendations for election of officers. Membership will have an opportunity to compare the credentials and past service of the officer nominees with sufficient time to permit any member to make an informed communication with the Council.

iii. Council has more direct information on credentials of officer candidates; Generally, the officers will be selected from people who have served the Section in the past. The Council works closely with Section members serving on committees and is most informed about the efforts and attributes of each nominee.

iv. Council works directly with officers; The officers and the Council coordinate efforts during the year and the selection of the officers by the Council will foster a closer working relationship.

v. Provides greater continuity of officers; Three new Council members are elected every year. Each of the officers other than the Chairman is elected every year. The six members of the Council not up for election will have had direct experience with the officers from the prior year and will be best able to ascertain if those officers would be qualified to assume the next highest office in the following year.

2. Reasons to oppose the Amendments

A. Elimination of floor nominations

i. Permits introduction of candidates as late as the electing meeting; If for any reason the membership becomes dissatisfied with the nominated parties after the closing of the nominations, there is no opportunity to remedy the same except by nomination from the floor.

ii. Candidates' credentials can be discussed at meeting; If nomination from the floor is required, the credentials of the floor nominee may be presented at that time.

B. Election of officers by Council

i. Removes right of membership to elect officers. The Officers provide the day-to-day leadership for the Section, subject to the policy responsibilities of the Council. This is particularly true for the election of the vice-chair which, pursuant to the Bylaws, becomes the chair of the Section for the following year. The position of officer is too important to remove from the direct vote of the membership.

ii. Permits annual evaluation and election of each officer position. Continuity of officers should be preserved only based on merit. Because only 3 new Council members are elected each year, the remaining 6 Council members may elect officers which would otherwise be unsatisfactory to the members voting at the meeting. By making each officer position elected at the annual meeting, annual evaluation is more assured. As the Council has continuity, continuity of the officers is not sufficiently significant to remove the vote of the officers from the membership.

The reasons described above are my own and not that of the Committee. Nevertheless, I identified those reasons in the dialogue among the Committee members.

After consideration of the reasons described above, I support the proposed Amendments.

I have not joined in either the Majority or the Minority Report because of my concerns regarding three issues addressed in each Report. First, both reports reference the events of last year's annual meeting in which floor nominations were received for what I believe to be the first time. I recollect that each elected position carried by one vote and I would hope that the election procedures set forth in our Bylaws, as proposed by the Amendments, can create a greater consensus for the most representative and qualified candidates. Secondly, the Majority and the Minority Report comment favorably and unfavorably respectively on the past performance of the officers and Council. It appears that the past performance may be in the eye of the beholder and I accordingly prefer to look forward through election procedures structured to assure the membership feels its officers and Council are responding to the Section's needs as a whole. Finally, I object to the characterization of the historical facts or the proposed Amendments as an issue divisive between large firms and small or solo practitioners. Each member of the Tax Section practices tax law and the Council and officers should recognize their obligation to provide opportunities for professional development through participation and continuing education for every member of the Section.

The Committee chose not to amend the Bylaws with regard to the important procedural concern that the election is conducted among members in attendance, without proxy. The meeting is generally sparsely attended with no quorum requirements. It is accordingly possible that a very small minority of the Section may elect representatives for all of the Section. I am prepared to wait to determine if contested elections increase attendance at the meetings and if voting does not fall into constituent blocks. With floor nominations permissible, proxy voting for individual candidates is difficult. Proxies delivered to attending members address only to some degree the issue if floor nominations are allowed. I urge the Council to consider proxy voting after some experience has been gained with regard to the operations of the voting process after the decision with regard to these Amendments.

BYLAWS OF THE SECTION OF TAXATION

OF THE STATE BAR OF TEXAS

~~II. BYLAWS~~

~~SECTION OF TAXATION~~~~of the State Bar of Texas~~

~~BYLAWS~~

~~(as amended through~~

(last revised on June 13, 2003)

ARTICLE I.

Name and Purpose

Section 1.1. **Name**. This Section shall be known as the Section of Taxation of the State Bar of Texas.

Section 1.2. **Purpose**. The purpose of the Section shall be to promote the objectives of the State Bar of Texas within the field of taxation, provide leadership in the practice of tax law, create a better understanding and cooperation between attorneys engaged in the practice of tax law, improve the education of attorneys and related professionals in the laws of taxation, promote the economic and professional interests of the members of the Section~~,~~ and serve the public good~~ and participate actively in the drafting, review and promotion of legislation and administrative rulings affecting state and federal tax law~~.

ARTICLE II.

Membership

Section 2.1. **Dues**. Any member of the State Bar of Texas~~ who desires to become a member of the Section shall~~, upon registering his or her name with the Secretary of the Section and payment ~~of a fee of $25.00 per year (effective for the fiscal year beginning June, 1997),~~for the then current year of dues as set from time to time by the Council, shall be enrolled as a member. ~~Members~~For each succeeding year, said dues shall be payable by the member in advance. Any member whose annual dues shall be more than six months delinquent or who ceases to be a member in good standing of the State Bar of Texas shall thereupon cease to be a member of this Section. Persons so enrolled shall constitute the membership of the Section.

Section 2.2. **Newly Licensed Attorney**. A one-year free membership shall be provided to each attorney newly admitted to the State Bar of Texas upon request by such attorney for such free membership. The time period allowed for application for the free membership shall be the year during which such attorney is admitted to the State Bar of Texas.

ARTICLE III.

Officers and Council

Section 3.1. **Officers**. The Officers of the Section shall be a Chair, Chair-Elect, Secretary, and Treasurer.

Section 3.2. **Council**. There shall be a Council, which shall consist of the Officers of the Section, together with eleven other members, nine of whom are to be elected by the Section as hereinafter provided and two of whom shall be the then serving Newsletter Editor and the Website Chair. Ex-officio members of the Council shall consist of the Chair of the Section for the immediately preceding year and three individuals selected by the Chair to serve during the term of the Chair. The three individuals selected by the Chair shall reside and work within the State of Texas and may consist of a professor of tax law at an accredited law school, an employee of the Internal Revenue Service, and an employee of the State of Texas Comptroller's Office.

Section 3.3. **Terms of Officers**. All Officers except the Chair shall be nominated and elected in the manner hereinafter provided~~ at each annual meeting of the Section~~, to hold office for a term beginning ~~at the close of the annual meeting of the Section at~~with the fiscal year for which they shall have been elected, and ending at the close of ~~the next succeeding annual meeting of the Section and~~such fiscal year or, if later, until their successors shall have been elected and ~~qualify~~qualified. The Chair-Elect shall, at the end of the Chair-Elect's term of office, become Chair for the next succeeding year.

Section 3.4. **Terms of Council Members**. Three members of the Council shall be elected at each annual meeting of the Section, for terms of three years beginning at the close of the annual meeting at which they shall have been elected and ending upon the earlier of such member's election as an Officer or the close of the third succeeding annual meeting of the Section. No person shall be eligible for election as a member of the Council if such person is then a member of the Council and has been a member of the Council continuously for a period of two years or more.

Section 3.5. **Removal**. If any Officer or elected member of the Council shall fail to ~~attend~~participate (in person or by telephone) in two consecutive meetings of the Council without reason acceptable to the Council, such member shall be automatically removed from the Council and, if applicable, as an Officer.

Section 3.6. **Vacancies**. If any Officer or other member of the Council at any time after election shall be removed as provided in Section 3.5 or shall die, resign or cease to be a member of the Section, the office of such member shall automatically be vacated without any action other than to note such fact in the minutes of the Council. During the time between annual elections of the Section, the Council may fill vacancies in its own membership other than for the office of Chair which shall be filled by the Chair-Elect. Persons so selected shall serve the unexpired term of the office vacated.

ARTICLE IV.

Nomination and Election of Officers and Council

Section 4.1. **Nominations**. ~~At least sixty~~Within thirty (~~60~~30) days ~~prior to~~following each annual meeting of the Section, the Chair shall ~~preside over and~~ appoint a Nominating Committee ~~of~~consisting of the Chair as an *ex officio* member and not less than three additional members of the Section who are not members of the Council~~, which~~. The first issue of the Texas Tax Lawyer following the annual meeting of the Section shall identify the members of the Nominating Committee and solicit from the members of the Section names of candidates for the offices of Secretary, Treasurer and Chair-Elect and three Council members for the succeeding year or to fill vacancies then existing for unexpired terms. Any person whose name is submitted as a candidate and who wishes to be considered for election as an officer or Council member shall complete and timely submit a candidate questionnaire (which shall be in such form as determined from time to time by the Nominating Committee). From the candidates who timely submit completed candidate questionnaires, the Nominating Committee shall make ~~and report~~ nominations ~~to the Section~~ for the offices of Chair-Elect, Secretary~~,~~ and Treasurer~~,~~ and members of the Council to succeed those whose terms will expire at the close of the ~~forthcoming annual meeting,~~Section's fiscal year and to fill vacancies then existing for unexpired terms. ~~At least thirty~~ At the Council's last meeting preceding by at least ninety (~~30) days prior to each annual meeting of the Section, written notice of the Nominating Committee report shall be given to each member of the Section, which notice shall be deemed given upon publication in the newsletter of the Section or deposit of the report~~ 90) days the Section's annual meeting for the year, the Nominating Committee shall report its nominations to the Council, and, from those nominated, the Council at its last meeting preceding the annual meeting for the year shall elect the Chair-Elect, Secretary and Treasurer to succeed those whose terms will expire at the close of the Section's fiscal year. Also, the Nominating Committee shall cause to be published in the last issue of the Texas Tax Lawyer preceding the Section's annual meeting for the fiscal year or by deposit with the United States postal service in a postpaid envelope bearing the record address of the Section member~~. Other nominations for the same offices~~ its report of nominations for members of the Council and all other candidates for such positions who timely submitted completed questionnaires and wish to stand for election. No other nominations for the office of Council member may be made from the floor of the annual meeting by members of the Section.

Section 4.2. **Elections**. ~~Elections at~~At the annual meeting of the Section ~~may be~~, the members of the Section present in person shall by majority vote (determined at the discretion of the Chair by voice or visible vote or written ballot) elect the members of the Council to succeed those whose terms will expire at the close of the annual meeting and to fill vacancies then existing for unexpired terms.

ARTICLE V.

Duties of Officers

Section 5.1. **Chair**. The Chair shall preside at all meetings of the Section and of the Council and shall formulate and present at the annual meeting of the State Bar of Texas a report of the work of the Section for the then past year. The Chair shall plan and supervise the agenda of the Section during the year and shall supervise all activities of the Section. The Chair shall perform such other duties and acts as usually pertain to the office.

Section 5.2. **Chair-Elect**. The Chair-Elect shall plan the annual meeting of the Section for the conclusion of the Chair-Elect's term of office including the arrangement of any presentations and speakers to the annual meeting and shall submit all such plans and arrangements to the Chair for approval. The Chair-Elect also shall supervise the committees of the Section, report to the Council on the activities of each committee and select for approval by the Council all officers and Council liaisons for each committee. During the disability of the Chair or upon the Chair's absence or refusal to act, the Chair-Elect shall perform the duties of the Chair, unless the Chair-Elect also is under disability, is absent or refuses to act and the Council shall have designated another person to perform the duties of the Chair. The Chair-Elect shall assist the Chair with the performance of such responsibilities as the Chair may request.

Section 5.3. **Secretary**. The Secretary shall be custodian of all the books, reports and records of the Section with the exception of the financial records. The Secretary shall keep a correct record of the proceedings of all meetings of the Section and the Council and shall maintain the roster of members of the Section and the committees within the Section. ~~With the Chair, the Secretary shall prepare a summary or digest of the proceedings of the Section at its annual meeting and shall submit the same to the Board of Directors of the State Bar of Texas for publication in the annual report.~~In conjunction with the Chair, as authorized by the Council, the Secretary shall attend generally to the business of the Section.

Section 5.4. **Treasurer**. The Treasurer shall be custodian of all financial reports of the Section and shall receive all dues and other funds paid to the Section. With the Chair, the Treasurer shall have full authority to appoint depositories of the funds of the Section, to make deposits thereto and to withdraw funds therefrom. With the assistance of the Chair-Elect, the Treasurer shall prepare and present to the annual meeting of the Section an annual budget projecting the receipts and expenditures of the Section during the fiscal year following the conclusion of the Chair-Elect's term of office. On behalf of the Section, the Treasurer shall submit to the Executive Director of the State Bar of Texas by July 15 each year a complete financial report for the preceding fiscal year ending May 31 which includes a balance sheet and income statement. Additionally, the Treasurer will submit to the accounting department of the State Bar of Texas on a monthly basis all bank statements, along with all canceled checks and deposit slips and the check register. The Treasurer shall have the responsibility to provide the required financial information to the State Bar of Texas. The authority of the Treasurer to invest funds of the Section shall be limited by the requirements of Section 6.02.06 of the Policy Manual of the Board of Directors of the State Bar of Texas (the "Board Policy Manual") which requires that Section funds must be invested in accordance with the parameters of Section 10.05 of the Board Policy Manual. A copy of Section 10.05 of the Board Policy Manual is attached hereto for reference by the Treasurer.

ARTICLE VI.

Duties and Powers of the Council

Section 6.1. **Authority**. The Council shall have general supervision and control of the affairs of the Section subject to the provisions of the ~~Constitution~~Charter and Bylaws of the State Bar of Texas and these Bylaws. It shall supervise the expenditure of any monies received as dues by the Section appropriated for the use or benefit of the Section. It shall not, however, authorize commitments to contracts which shall entail the payment of any money during any fiscal year beyond that in the treasury of the Section unless the money shall have been previously appropriated to the Section for that fiscal year by the Board of Directors of the State Bar of Texas. The Council shall appoint a ~~an Editor~~ Website Chair and ~~Assistant~~ a Newsletter Editor~~ for the newsletter of the Section~~ from time to time, assuring that the term of office for any ~~Editor~~such person is limited to no more than two consecutive fiscal years. The Newsletter Editor and the Website Chair shall each be a Council member during the term of his or her service in such position.

Section 6.2. **Committees**. The Council may, or authorize the Chair to, appoint committees from Section members to perform such duties and exercise such ~~powers~~power as the Council may direct, subject to the limitations of these Bylaws and the Constitution and Bylaws of the State Bar of Texas. Officers and Council liaisons of committees designated by the Chair-Elect shall be approved by the Council. Until otherwise determined by action of the Council or pursuant to action of the Chair authorized by the Council, the standing committees of the Section shall be as follows: Continuing Legal Education, Corporate Tax, Employee Benefits, Energy and Natural Resources, Estate and Inheritance Tax, External Relations, International Tax, Partnership and Real Estate Tax, Property Tax, Solo Practitioner and Small Firm Committee, State and Local Tax, Tax Controversy, Tax-Exempt Finance, Tax-Exempt Organizations, Newsletter and Website/E-Communications.

Section 6.3. **Committee Oversight**. The Council shall monitor the committees of the Section through the reports of the Chair-Elect. The Council shall require each committee to submit at least one article for publication in the newsletter of the Section during each year and shall make an annual determination regarding the establishment of new committees and termination of existing committees.

Section 6.4. **Quorum; Actions**. A quorum of the Council for the conduct of business shall require a majority of the Council (present either in person or participating by means of a telephonic conference through and by which each participant may hear the other) and all binding actions of the Council shall be by a majority vote of the whole Council.

Section 6.5. **Voting**. Members of the Council when ~~personally present~~participating at a meeting of the Council ~~shall vote in person~~(either in person or by means of telephonic conference through and by which each participant may hear the other) shall vote on all matters properly before the meeting, but when absent may communicate their vote in writing upon any proposition to the Secretary and have it counted with the same effect as if cast personally at such meeting.

Section 6.6. **Propositions**. The Chair of the Section may, and upon the request of any member of the Council shall, submit or cause to be submitted in writing to each member of the Council, any proposition upon which the Council may be authorized to act, and the members of the Council may vote upon such proposition so submitted by communicating their vote thereon in writing over their respective signatures to the Secretary, who shall record upon the minutes each proposition so submitted, when, how, at whose request submitted, and the vote of each member of the Council thereon, and keep on file such written and signed votes.

Section 6.7. **Outstanding Texas Tax Lawyer Award**. The Council may award the designation "Outstanding Texas Tax Lawyer" to a qualified nominee as frequently as once each year. A "qualified nominee" shall: 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. "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" includes, but is not limited to: "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 sector; and teaching taxation law or related subjects at an accredited law school. Current members of the Section may submit nominations to the Secretary. The Council shall select a winner from among the qualified nominees by voting on a proposition. In selecting a winner, the Council shall 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 other 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. The Council may authorize the purchase of a suitable plaque, trophy, or similar symbol to acknowledge each winner. The Council may designate the time and place of any ceremony for the presentation of the award. The Council may reimburse the winner's expenses incurred in connection with attending such a ceremony. The Council may authorize the waiver of a winner's registration fees associated with minimum continuing legal education programs sponsored by the Section for a period of one year after the date of the award ceremony.

ARTICLE VII.

Meetings

Section 7.1. **Annual Meeting of Section**. The annual meeting of the Section shall be held during the annual meeting of the State Bar of Texas, and at the same city or place, with such program and order of business as may be determined by the Chair and approved by the Council.

Section 7.2. **Special Meetings of Section**. Special meetings of the Section may be called by the Chair upon approval of the Council~~,~~ at such time and place ~~and upon such notice as the Council may determine~~as designated in a notice (either written or by electronic mail) sent to each Section member at least ten days prior to the date designated for such special meeting.

Section 7.3. **Voting at Section Meetings**. The voting members of the Section present at any meeting of the Section shall constitute a quorum for the transaction of business. All binding action of the Section shall be by a majority of the members present at the meeting.

Section 7.4. **Meetings of Council**. Special meetings of the Council may be called by the Chair at such time and place as designated in a written notice sent to each Council member at least ten days prior to the date designated for such special meeting. Regular meetings of the Council shall be had in the fall, winter and spring at such time and place as the Chair may designate in a notice (either written ~~notice~~or by electronic mail) sent to each Council member at least ten days prior to the date designated for such regular meeting~~. The annual meeting of the Council shall take place immediately after the annual meeting of the Section~~.

Section 7.5. **Council Voting by Electronic Mail**. The Chair may submit or cause to be submitted in writing (including by fax or e-mail) to each of the members of the Council, any proposition upon which the Council may be authorized to act, and the members of the Council may vote thereon, in writing (including by fax or e-mail) over their respective signature (however, in the case of e-mail, no signature is required as long as an e-mail is received from the recognized e-mail address of the member), to the Secretary, who shall record upon the minutes each proposition so submitted, when, how, at whose request same was submitted, and the vote of each member of Council thereon, and keep on file such votes. If the votes of a majority of the members of the Council so recorded shall be in favor of such proposition, such majority votes shall constitute the binding action of the Council.

ARTICLE VIII.

Miscellaneous

Section 8.1. **Fiscal Year**. The fiscal year of the Section shall begin upon the close of the annual meeting of the Section and end at the close of the next succeeding annual meeting.

Section 8.2. **Prohibition on Compensation**. No salary or compensation shall be paid to any Officer, member of the Council or member of a committee unless by approval of the Council such person is compensated for work done outside the meetings of the Council on a special study or project.

Section 8.3. **Reimbursement of Expenses**. Members of the Council and other persons requested to attend a Council meeting or any other meeting on behalf of the Section shall be reimbursed for actual out-of-pocket costs incurred in attending any such meeting subject to the applicable requirements of the State Bar. Members of any committee may be reimbursed for actual out-of-pocket costs incurred in attending any meeting of the committee or any other meeting on behalf of the Section, provided the Chair has approved reimbursement before such meeting and subject to the applicable requirements of the State Bar.

Section 8.4. **State of Texas**. No action, policy determination, or recommendation of the Section or any committee thereof shall be deemed to be, or be referred to as, the action of the State Bar of Texas prior to submission of the same to, and approval by, the Board of Directors of the State Bar of Texas, the General Assembly of the State Bar of Texas in annual convention, or duly authorized referendum of the State Bar of Texas. Any resolution adopted or action taken by the Section may be reported by the Chair to the annual meeting of the State Bar of Texas for action thereon upon request for such action by the Council or a majority of the members present at any meeting of the Section.

Section 8.5. **Amendment**. These Bylaws may be amended at any annual meeting of the Section. All amendments must first be approved by the Council before being presented to and approved by a majority vote of the members of the Section present at the annual meeting of the Section, and shall not become effective until approved by the Board of Directors of the State Bar of Texas.

Section 8.6. **Web Site Copyright Policy**. Programs, seminars, and symposia (collectively, "Program" or "Programs") shall be encouraged as a means to facilitate continuing legal education and to promote the purposes of the Section. The Section acknowledges the author's right to copyright his or her work, articles, or other written materials used in or at Section-sponsored Programs. The Section encourages the Program Director(s) of all Section-sponsored Programs to obtain from each author permission to reproduce, distribute and display the author's work either by itself or in a collection of works on computer disk or on the Section's Internet web site, and use such other means of distribution and display in disseminating the author's work to Section members and the public. Nothing contained in this Section 8.6 shall prohibit or prevent the reproduction, distribution and display of tax-related works from sources other than Section-sponsored Programs provided that permission is first obtained from the author(s) creating such work.

[AS APPROVED, BOD 01/23/04]

STATE BAR BOARD OF DIRECTORS GUIDELINES FOR ELECTION OF PRESIDENT-ELECT

At the January 23, 2004, meeting of the State Bar Board of Directors, revisions to the President-elect guidelines were approved. Nominations & Elections Subcommittee Chair Kelly Frels has requested that we share the following with the Members of the Tax Section.

2.01 Election of President-elect

2.01.01 General. The President-elect shall be elected by vote of a majority of those members of the State Bar who voted in such election. Such election shall be held in April or May of each year. The person so elected shall assume the office of President-elect at the next annual meeting following the succession of the then President-elect to the office of President.

2.01.02 Qualifications. Any lawyer who meets the eligibility requirements for Officers set forth in the State Bar Act and the State Bar Rules is eligible for nomination for President-elect, provided such lawyer is not currently serving as a Board Member.

2.01.03 Nomination. At its regularly scheduled January meeting, the Board shall nominate by a majority vote, two or more members of the State Bar to stand for election to the office of President-elect. Such nominations shall be made in accordance with policies and procedures adopted and maintained by the Board and contained in Policy Supplement Section 2.01. Any other qualified member of the State Bar shall also be privileged to stand for election to that office when a written petition, in a form prescribed by the Board and signed by no less than five percent of the active members of the State Bar who are in good standing, is filed with the Executive Director on or before March 15 preceding the election for the ensuing year.

2.01.04 Policies & Procedures. The Board shall adopt and maintain policies and procedures governing the nomination, Campaigns and election of the President-elect which shall be contained in Policy Supplement Section 2.01.

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Policy Supplement S2.01 Nominations & Elections of President-Elect

S2.01.01 General. The following guidelines are adopted pursuant to the State Bar Act and the rules promulgated thereunder. The relevant provisions of that act and those rules (Texas Government Code, Title 2, Subtitle G, Chapter 81; State Bar Rules, Art. IV, Sec. 11) are incorporated within these guidelines.

S2.01.02 Definitions

A. Candidate/Potential Nominee. For purpose of these Guidelines, "Candidate" and "Potential Nominee" shall mean any person whose name is submitted, pursuant to the provisions of Section S2.01.05 below, for consideration by the Board as a Nominee to stand for election to the office of President-elect for the following year, and any person who, in accordance with Section S2.01.03 below, declares his or her intent in writing, files a written petition, and obtains the Executive Director's certification of that petition.

B. Nominee. For purposes of these Guidelines, "Nominee" shall mean any Candidate/Potential Nominee who is nominated by the Board, pursuant to the provisions of Sections 2.01.03-2.01.05 below, and any Candidate/Potential Nominee who declares his or her intent in writing and files a written petition pursuant to the provisions of Section 2.10.03 below.

C. Campaign. For purposes of this section, "Campaign" means activities and communications in any form by or on behalf of a Nominee for the purpose of gaining votes for the election of the Nominee as President-elect.

D. Professional Acquaintance. For purposes of this section, "Professional Acquaintance" means a Texas licensed attorney, including those on inactive status, who a soliciting attorney or Candidate knows personally. Mere knowledge of the lawyer by name or reputation or membership in the same professional, social or alumni organization, specialty bar, section and the like does not qualify as a Professional Acquaintance.

E. Endorse. For purposes of this section, "Endorse" means an attorney or organizational representative stating or publishing support for a Candidate. Endorse does not include an attorney stating for whom he or she will vote if asked by another.

S2.01.03 Nominations. At its regularly scheduled January meeting each year, the Board, on recommendation by the Nominations and Elections Subcommittee, shall nominate by a majority vote two or more members of the State Bar to stand for election to the office of President-elect for the following year. Any other qualified member shall also be privileged to stand for election to that office when a member declares his or her intent in writing to the Chair of the Board not earlier than the adjournment of the Board's September meeting preceding the election for the ensuring year and not later than the commencement of the Board's January meeting preceding the election, when a written petition, in a form prescribed by the Board and signed by no less than five percent of the active members of the State Bar who are in good standing, is filed by or on behalf of such member with the Executive Director on or before March 15 preceding the election for the ensuing year and such petition is certified by the Executive Director. The Executive Director shall either certify or reject such petition within five (5) business days following receipt of the petition by the Executive Director. Any disputes arising from the Executive Director's decision shall be resolved by the Nominations & Elections Subcommittee in accordance with S2.01.15 and the State Bar Rules.

S2.01.04 Candidate Pools. The Nominees for President-elect shall be selected from three different Candidate pools that rotate on a three-year cycle. In the first year of that cycle, the Nominees shall be selected from State Bar members whose principal office is in Bexar, Dallas, El Paso, Harris, Tarrant, and Travis counties. In the second year of the cycle, the Nominees shall be selected from State Bar members whose principal office is outside the six metropolitan counties cited above. In the third or “open” year of the cycle, the Nominees shall be selected from the Candidate pool of all State Bar members, without regard for the county of their principal office. In any year of any three-year cycle the Board may nominate two or more Nominees from the same county.

S2.01.05 Selection of Nominees. The Board shall select President-elect Nominees as follows:

A. In August preceding the January meeting at which the Board nominates its Nominees, the Nominations and Elections Subcommittee chair shall notify Texas bar associations representing the State Bar’s diverse membership and State Bar sections, divisions, and committees that the Nominee selection process has begun. The chair shall request from those groups the names and background information of potential Candidates, explaining the criteria for selection described in subsection C.

B. The Board shall publish its intent to select Nominees for President-elect in the September issues of the *Texas Bar Journal*, the *Texas Lawyers’ Civil Digest*, and the *Texas Lawyers’ Criminal Digest*, soliciting potential Candidates. The publication shall contain the criteria for Nominee selection described in subsection C. Anyone submitting a name for consideration should first obtain that person’s written consent to have his or her name submitted.

C. Subject to Policy Supplement S2.01.04, any lawyer in good standing with the State Bar is eligible for nomination, provided such lawyer is not currently serving as a Director. The Board shall select the best qualified Nominees every year, and choose its Nominees with the objective of ensuring that, over a period of years, the office of the President includes men and women, ethnic and racial minorities, lawyers from large and small firms and solo practitioners, and members from urban and rural areas of the State. In doing so, the Board shall consider a potential Candidate’s involvement in State Bar committee work, knowledge of State Bar operations, participation in local and specialty bar associations, and other activities demonstrating leadership ability. Although prior membership on the Board is not a prerequisite to nomination, it is important in determining whether a lawyer is a qualified Nominee.

D. The Board may also solicit potential Candidates whose names have not been submitted through the process described in subsections A and B. Persons solicited for candidacy must meet the criteria described in subsection C.

E. As part of the selection process, each Potential Nominee should be asked to submit a resume and a brief statement indicating the reasons for his or her interest in serving as President. The Nominations and Elections Subcommittee may interview Potential Nominees.

F. A Potential Nominee may confirm to others that he or she is a Potential Nominee prior to actual nomination by the Board.

G. A Nominee may also confirm to others at anytime prior to the out-of-office Campaign period that he or she is a Nominee.

S2.01.06 Notification of Nomination. Insofar as it is possible, the Board’s Nominees shall be notified of their nominations at the same time on the same day.

S2.01.07 Announcement of Nominations. As soon as reasonably possible after the Nominees for President-elect are named by the Board, their names, the cities of their respective residences, and their biographical information, together with the procedure for additional nominations by petition under the State Bar Rules, shall be published in the T*exas Bar Journal*, the *Texas Lawyers’ Civil Digest*, and the *Texas Lawyers’ Criminal Digest*.

S2.01.08 Campaign Activities.

A. Potential Nominees recommended by the committee may not Campaign before their official nominations by the Board.

B. The Nominees may not Campaign until they have met with the Nominations and Elections Subcommittee as required in Policy Supplement S2.01.09 or immediately following the adjournment of the Board meeting at which they are nominated, whichever is the latest, and must cease campaigning at midnight of the date on which the ballots are sent out (the “Campaign period”).
C. Nominees may not Campaign outside their offices before March 15 or after the ballots are sent out.

D. Nominees may not solicit, approve, or condone communications by local bars, specialty bars, law school alumni associations, bar association sections or committees, or other bar-related groups seeking to support their candidacies.

E. No Nominee, or anyone acting on the Nominee’s behalf, may solicit votes by mailings, faxes, or emails to selected groups within the Bar, or by mailings, faxes, or emails to local or specialty bars, unless every member of such selected group within the Bar and/or such local or specialty bars is a Professional Acquaintance of the person making the contact.

F. Nominees may not solicit, approve, or condone solicitations in any publications other than the *Texas Bar Journal*. If any articles about a Nominee appear in any publication, the publishing entity should provide equal space and time to the same or similar articles for all other Nominees. The Executive Director or designee shall notify section chairs and local, specialty and minority bars of this policy.

G. Nominees may not distribute substantially similar letters, emails, including blast emails, or facsimiles to groups of lawyers, unless every member of such selected group within the Bar and/or such local or specialty bars is a Professional Acquaintance of the Nominee. Nominees may, during the Campaign period, send letters, emails or facsimiles and make telephone calls to lawyers they do not know only if they are one-to-one and individualized.

H. Solicitation by persons other than Nominees or Texas licensed lawyers (including inactive lawyers) supporting the Nominees, through the use of telephone, email or other methods of communication to lawyers and Professional Acquaintances is prohibited.

I. Nominees may not seek or publicize endorsements from local or specialty bar groups and may not publicize endorsements or support from current Officers or Directors.

J. Members of the Executive Committee and Nominations and Elections Subcommittee may not endorse, support or participate in the Campaign for President-elect. Current Officers and Board Members shall not, in their official capacities, endorse any Candidate for State Bar of Texas offices.

K. Nothing herein shall prohibit the establishment of a steering committee or group consisting of Professional Acquaintances of the Nominee as defined herein for the purpose of assisting the Nominee in the Campaign prior to the commencement of, or during, the Campaign period.

L. Expressions of support for a Nominee in an individual lawyer's mailings may be made if those are on the lawyer's personal stationery, or on his or her law firm's or company's stationery, directed to his or her Professional Acquaintances and mailed by the lawyer or under his or her direct supervision and at his or her own expense. Groups of lawyers (two or more) may not jointly solicit support for any Nominee.

M. One-to-one, individualized telephone calls or emails expressing support for a Nominee to Professional Acquaintances of the individual caller or sender are permitted. List-serves and group emails are not allowed unless every person on the list-serve or email group is a Professional Acquaintance of the sender.

N. Attendance by the Nominees at the TYLA Board of Directors meeting and local bar association meetings is allowed, if invited.

In exceptional circumstances, such as invitations to speak made by the TYLA Board of Directors or local bar associations, the Nominees may jointly apply to the Nominations and Elections Subcommittee for a dispensation to undertake campaigning outside the office before March 15.

S2.01.09 <u>Meeting with Nominations & Elections Subcommittee</u>. The Nominees shall jointly meet with members of the Nominations and Elections Subcommittee to discuss election rules and procedures before the beginning of the Campaign period.

S2.01.10 <u>Mailing of Ballots</u>. On April 15, or on the first working day following April 15 if April 15 falls on a weekend, an official ballot listing the names of all Nominees shall be mailed, at the same time the ballots for the election of Directors are mailed, to each member of the State Bar who is entitled to vote. A combined ballot for the office of President-elect and for the office of Director may be used in bar districts in which an election for a Director is to be conducted.

S2.01.11 <u>Campaign Brochures</u>. Each Nominee is responsible for the design and content of a single Campaign brochure, which shall be used as the Nominee's sole handout during the election. The State Bar will print the brochures in a four-color process, using the same size and quality of paper for each Nominee's brochure.

A. In designing the brochures, Nominees should:

1. seek to be as informative as possible;

2. limit photographs to pictures of the Nominee and his or her family; and

3. neither refer to nor cite endorsements of the Nominee by groups or individuals.

B. The Nominations and Elections Subcommittee will review all brochures before printing to ensure compliance with the guidelines.

C. Brochures used in the election for President-elect shall be printed and mailed at State Bar expense, along with the official ballots, to each voting member.

D. The State Bar of Texas shall pay, in addition to the printing expense of the brochures included with the ballots, the cost of printing such reasonable amount of such extra brochures as the Nominations and Elections Subcommittee may determine is appropriate.

E. Nominees may purchase additional copies of the brochures, for their own use, at cost.

S2.01.12 <u>Campaign Expenditures</u>. Nominees for the office of President-elect shall not expend more than $15,000 in Campaign expenses, not including expenses for transportation and lodging during the Campaign, unless the Nominees agree on a different amount not to exceed $25,000. The State Bar shall reimburse Nominees up to $10,000 for actual out-of-pocket Campaign expenditures. This reimbursement is in addition to, and not in lieu of, Campaign expenses currently being paid by the State Bar, provided, however, that if in any year more than two Candidates are nominated for the office of President-elect, the aggregate expenditure by the State Bar under this provision will not exceed more than $20,000 for all Nominees. Nominees shall submit verified reports of all Campaign expenditures, including expenses for transportation and lodging, within 90 days after the Campaign ends.

S2.01.13 <u>Use of the Internet</u>. Nominees may Campaign on the Internet during the Campaign period described in Policy Supplement S2.01.08.B, by use of a personal website or web page. However, the information displayed on the web page or website is limited to the following:

A. The information and pictures published in the Nominee's pre-approved Campaign brochures as described above;

B. Information regarding scheduled appearance dates at State Bar of Texas, local bar association or private meetings; and

C. Any Campaign information that is printed in the *Texas Bar Journal* regarding the Nominee.

D. All information to be published on a personal web page or website must be submitted to the chair of the Nominations and Elections Subcommittee for approval before publication.

The information included in A, B, C and D will be posted on the State Bar website.

Nominees may also use a State Bar portal on the world-wide web to post their positions on issues facing the bar and respond to inquiries from lawyers.

S2.01.14 <u>Campaign Conduct</u>. Each Nominee and his or her supporters shall make a reasonable effort to conduct his or her Campaign in a dignified manner. In communicating with Bar member voters, whether by letter, card, fax, email or telephone, Nominees and their supporters shall concentrate on the merits of their choice and avoid criticism of the other Nominees.

S2.01.15 Campaign Oversight. Nominees shall consult with the chair of the Nominations and Elections Subcommittee concerning the interpretation of these rules. The Nominations and Elections Subcommittee shall supervise the guidelines, eligibility, nominations, campaign and election to ensure compliance with the rules and shall resolve all such disputes and decide all penalties. Decisions and interpretations made by the Nominations & Elections Subcommittee hereunder shall be final.

A. In the event of any violation of the rules by or on behalf of a Nominee, the Nominations and Elections Committee shall determine if the violation is minor or major.

B. In the event of a minor violation, the Nominations and Elections Subcommittee may allow the other Nominee to engage in like activity.

C. In the event of a major violation, the Nominations and Elections Subcommittee may publicly censure the Nominee committing the violation. Such public censure may be written by the Nominations and Elections Subcommittee and placed in the envelope with the official ballot and brochures of the Nominees or disseminated to the members of the State Bar in whatever manner the committee deems appropriate.

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

February 13, 2004

The Leadership of the Tax Professional Organizations

Dear Tax Professionals:

I am honored that Commissioner Everson has asked me to take on the leadership of the Office of Professional Responsibility (OPR). This Office, and the Mission and people it serves, plays a prominent role in sound and effective tax administration practices. It is our goal to fully develop and use the authority of this office to detect and deter unethical practitioner conduct and to promote the highest standards of professionalism in the practitioner community.

Some of the priorities we have established for OPR are to:

1. **Maintain, and enhance as needed, the close working relationship between OPR and the tax professional community**.
We view the tax professional community as a key partner in effective tax administration that can play a vital role in helping us fulfill our Mission. Tax professionals frequently are the first to know of trends that can undermine tax administration and erode public confidence in the profession. In addition, tax professionals frequently establish and enforce standards of conduct which serve to promote the highest standards of integrity and professionalism. We look forward to maintaining an ongoing dialogue with the leadership of all the tax professional organizations.

2. **Train and develop a largely new staff within OPR.**
In the past year the Staff in the Office of Professional Responsibility has more than doubled; the number of attorneys on staff has practically tripled and we have added three paralegals. We have also added additional analytical and support personnel. We have been fortunate in being able to attract people who are highly capable and talented. To develop these individuals and promote consistency and efficiency in the way we perform or duties, we are implementing a formal training regimen within OPR. To bring practitioner perspective and expertise to our training, we have enlisted the assistance of Tom Cooke, a distinguished Professor from Georgetown University and active member of the practitioner community, to participate in our training.

3. **Maintain Circular 230 as a viable tool to fulfill the Mission of the Office of Professional Responsibility.**
The last substantive revision to Circular 230 was the July 2002 issuance. Trends in tax administration can change quickly and it is essential that the provisions of Circular 230 keep pace. A notice of proposed rulemaking containing changes to the tax shelter provisions of Circular 230 is out for public comment with public hearings scheduled on February 19, 2004. We are currently working with Chief Counsel, the Treasury Department and other interested stakeholders on proposed revisions to the non-shelter provisions of Circular 230. It is our goal to work closely with key stakeholders to promote meaningful, reasonable and clearly understood changes to Circular 230, that will provide needed guidance to the public and facilitate effective tax administration.

4. **Ensure the authority and capability of the Office of Professional Responsibility are fully integrated into the Service's Enforcement Strategy.**
The overwhelming majority of tax professionals adhere to high standards of conduct and integrity; these individuals and firms are to be applauded for their support of our system of tax administration. There are, however, some practitioners who conduct their business in a manner that is detrimental to our Nation's tax system and who provide a gross disservice to any taxpayer engaging them. We are working closely with the Division Commissioners, Criminal Investigation and other components of the Service to ensure that we identify and focus on this practitioner misconduct, and we intend to leverage all our capabilities in a coordinated fashion to address these problems.

We look forward to working closely with the tax professional community and welcome your thoughts on how this office can most effectively detect and deter professional misconduct and foster the highest level of integrity among tax professionals. Please send any thoughts or suggestions you might have to our e-mail account at OPR@irs.gov. We would also be grateful if you would forward this message to your constituency as you deem appropriate.

Sincerely,

Cono R. Namorato
Director
Office of Professional Responsibility

CORPORATE TAX: RECENT DEVELOPMENTS

by Brandon S. Jones[1]

1. Attribute Reduction in Consolidated Groups

Until recently, the application of Code Section 108 attribute reduction has been somewhat uncertain in the consolidated group context. To provide some guidance on the issue, the IRS issued temporary and proposed regulations under Code Section 1502 in September of 2003. However, these regulations have recently been amended to provide the IRS with a greater ability to reach the tax attributes of non debtor members.

Under the September 2003 regulations, tax attributes of the debtor member were to be reduced before the tax attributes of non debtor members could be reduced. Only if the debtor member realized an amount of discharge of indebtedness income exceeding its tax attributes could the tax attributes of non debtor members also be reduced. Under such regulations, tax attributes attributable to the debtor member included (i) consolidated attributes attributable to the debtor member, (ii) attributes that arose in separate return limitation years of the debtor member and (iii) the basis of property of the debtor member. To the extent that the amount of discharge of indebtedness income excluded by the debtor exceeded these tax attributes, consolidated tax attributes attributable to non debtor members and tax attributes attributable to a separate return limitation year ("***SRLY***") of a non debtor member could then be reduced, provided, that that the debtor member was a member of the SRLY subgroup with respect to those attributes.

Unsatisfied with its ability to reach certain tax attributes of non debtor members from which the debtor could benefit, the IRS determined that the September 2003 regulations should be amended to provide for the reduction of all tax attributes that could potentially be used by the debtor member. Thus, T.D. 9090 amended the regulations to add to the list of tax attributes subject to reduction (after the tax attributes attributable to the debtor member are reduced), those attributable to non debtor members (except for asset basis) that arise in a separate return year or that arise in a SRLY to the extent that no SRLY limitation applies to the use of such tax attributes by other members of the group.

These amendments to the September 2003 regulations generally apply to discharges of indebtedness that occur after August 29, 2003, but only if the discharge occurs during a taxable year the original return for which is due after December 10, 2003.

2. Ruling Allows Post-Spin Recapitalization to Alter Voting Associated with Stock of Controlled

Code Section 355 provides for the tax-free distribution of stock in a controlled subsidiary ("***Controlled***") by a distributing corporation ("***Distributing***"), provided that, in addition to certain other requirements being met, "control" of Controlled is distributed to the shareholders of Distributing. For purposes of this rule, control means ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation. Thus, it is possible for Distributing to distribute enough of Controlled to satisfy the requirement of Code Section 355 without giving up 80% or more of the value in Distributing, provided the distributed stock and retained stock are set up as two separate classes of stock with different voting rights or pursuant to a recapitalization, has stock with different voting rights.

There are many reasons for establishing different voting rights among shares in a corporation. However, what happens if Controlled is distributed in a tax-free spin under Code Section 355 and the voting rights associated with the stock of Controlled are subsequently readjusted (pursuant to a recapitalization) to avoid unwanted disparities in the price of stock in Controlled that are attributable solely to voting differences?

The IRS has addressed this issue on three separate occasions, the latest being PLR 200403041. There, the IRS ruled that an adjustment to the voting rights associated with the stock of Controlled following a spin off of Controlled by Distributing did not cause the prior spin, which was otherwise tax-free under Code Section 355, to become taxable. The IRS found it significant that (i) there was no intention at the time of the spin to readjust the voting rights associated with shares of Controlled, (ii) there was no expectation of the circumstances that could result in the need or desire to readjust the voting rights and (iii) a considerable amount of time had elapsed since the initial recapitalization which resulted in the different voting rights and since the spin took place.

While this ruling should provide taxpayers with some level of comfort, it is possible that its application could become limited in the future. Specifically, because this issue has already been addressed by the IRS on three occasions, it could become more difficult for taxpayers to take the position that there was absolutely no expectation that the shares could begin trading at disparate prices, resulting in a need or desire to readjust the voting rights. Consequently, the IRS may begin take the position that there was an intention to readjust the voting rights as of the date of a prior spin and that the spin should not qualify for tax-free treatment under Code Section 355.

3. New Regulation Addresses Capitalization of M&A Expenses

Whether certain expenses, including compensation, paid or incurred in connection with capital asset acquisitions must be capitalized has been a subject of much debate. Many cases, most notably *Lincoln Savings* and *Indopco*, have addressed the issue to some degree. However, the IRS recently finalized Treasury Regulation Section 1.263(a)-5 (the "***Regulation***"), which establishes new guidelines relating to the capitalization of amounts paid or incurred to facilitate mergers and acquisitions and certain other transactions ("***Covered Transactions***"). Generally these rules will apply to both the acquirer and the target.

Among the list of Covered Transactions are (i) a taxable acquisition of the assets of a trade or business, (ii) a taxable acquisition of controlling interest in an entity carrying on a trade or business and (iii) a tax-free corporate reorganization. However, the Regulation only applies to amounts paid or incurred to facilitate such Covered Transactions. It does not directly address the treatment of amounts paid or incurred for the purchase of tangible or intangible property (*i.e.,* the assets or stock of target) in such Covered Transaction. In addition, it should be noted that under the Regulation, amounts paid or incurred to integrate the business operations of the taxpayer with the business operation of another in a

Covered Transaction does not facilitate the Covered Transaction. In general, under the Regulation, amounts are deemed to facilitate Covered Transactions if they are paid or incurred in the process of investigating or otherwise pursuing the transaction, as determined by all the facts and circumstances. Amounts paid or incurred to determine the price or value of a Covered Transaction are deemed to be paid or incurred in the process of investigating or otherwise pursuing the transaction. While the fact that that an amount would (or would not) have been paid but for the transaction is relevant to the analysis, it is not conclusive.

Despite the general rules noted above, certain safe harbors apply to employee compensation, overhead and de minimis costs. Specifically, amounts paid or incurred for these items are treated as amounts that do not facilitate a Covered Transaction unless the taxpayer elects to treat them as such. For purposes of this rule, employee compensation includes not only amounts paid to an employee of the taxpayer but also annual compensation paid to directors of the company and amounts paid for most secretarial, clerical or administrative support provided by persons who are not employees of the taxpayer. De minimis costs include amounts (other than employee compensation and overhead) paid in the process of investigating or otherwise pursuing a transaction covered by the Regulation, if, in the aggregate, the amounts do not exceed $5,000.

Significantly, pursuant to the Regulation, amounts paid by the taxpayer (other than amounts paid for certain inherently facilitative actions identified below) in the process of investigating or otherwise pursuing *most* Covered Transactions are deemed to facilitate the transaction only if the amounts relate to activities performed on or after the earlier of the date on which a letter of intent, exclusivity agreement, or similar written communication (other than a confidentiality agreement) is executed by representatives of the acquirer and the target or the date on which the material terms of the Covered Transaction (as tentatively agreed to by representatives of the acquirer and the target) are authorized or approved by the taxpayer's board of directors (the "***Bright Line Date***"). In the case of a transaction that does not require authorization or approval of the taxpayer's board of directors the relevant date is the date on which the acquirer and the target execute a binding written contract reflecting the terms of the transaction. Please note, that the "Bright Line Date" is a significant change from the "final decision" date established by the court in *Wells Fargo & Co. v. Comm.*, 224 F3d 874 (8th Cir. 2000).

The Regulation lists a number of "inherently facilitative" items that must be included in the capitalized acquisition costs even if paid or incurred before the Bright Line Date. Actions or activities in this category that most frequently occur before such date include (i) negotiating the structure of the transaction (including negotiation of rejected alternatives), (ii) providing tax advice on the structure of the transaction (including tax advice on rejected alternatives) and (iii) preparing documents to effectuate the transaction (including documents relating to rejected alternatives).

ENDNOTES

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PARTNERSHIP TAXATION: RECENT DEVELOPMENTS

by Jennifer E. Stewart[1]

The following is a summary of selected current developments in partnership taxation.

IRS Issues Notice That Withdraws Notice 98-5 and Warns of Forthcoming Section 704(b) Regulations Addressing Inappropriate Foreign Tax Credit Results

On February 17, the Treasury Department and the IRS issued Notice 2004-19. It, along with Notice 2004-20, focuses on foreign tax credit abuses.

- Notice 2004-19 specifically highlights issues pertinent to partnership taxation as follows:

- Notice 98-5 is withdrawn, and Treasury and IRS will not issue regulations that apply the "economic profit test" of that notice.

- Transactions will no longer be considered listed transactions solely because they are the same as, or substantially similar to, transactions described in Notice 98-5; however, Treasury and IRS are working on changes to the tax shelter disclosure regulations to require reporting of potentially abusive foreign tax credit transactions.

- IRS and Treasury will challenge abusive foreign tax credit transactions using existing law, such as the step transaction and substance over form doctrines, debt-equity principles, the partnership anti-abuse rules of Treas. Reg. Section 1.701-2, the substantial economic effect rules of Treas. Reg. Section 1.704-1, and Section 269.

- Regulations under Section 704 will be issued "shortly" addressing special allocations of foreign taxes among partners that are inconsistent with the allocation of related foreign income.

For any existing partnership that involves foreign income and U.S. partners, practitioners should give careful consideration in determining how these new rules could affect the sharing of foreign tax expense among the partners in the partnership. Further, practitioners should be aware of this issue when analyzing partnership agreements to determine whether the agreement's partnership allocations will be respected and the economic goals of the parties are met.

Revenue Ruling Addresses Application of Treaties to Partnership Income

On January 29, 2004, the IRS released Rev. Rul. 2004-3, which holds that a nonresident partner in a service partnership will be subject to U.S. income tax on his allocable share of partnership income to the extent that such income is attributable to a fixed base in the United States (under Article 14 (Independent Personal Services) of the U.S.-Germany Income Tax Treaty), *regardless of whether the nonresident partner performs services in the United States*. The ruling further states that this holding applies in interpreting other U.S. income tax treaties with a "same or similar" provision to Article 14 of the U.S.-Germany Income Tax Treaty.

Rev. Rul. 2004-3 represents a marked departure from the positions stated in the Technical Explanation to the 1996 U.S. Model Income Tax Treaty and in PLR 9331012. In both that Technical Explanation and in PLR 9331012, it was concluded that a nonresident individual partner of a service partnership that has a fixed base in the United States would *not* be taxed in the United States on his distributive share of the partnership's income attributable to the fixed base, if the services were performed by other partners. However, the Technical Explanations to a number of U.S. income tax treaties that entered into force after the publication of 1996 U.S. Model state that the income derived by a partner resident in a Contracting State that is attributable to independent personal services performed in the other Contracting State through a partnership with a fixed base in that other State *may be taxed in the other State regardless of whether the services are performed by the partner himself, other partners in the partnership, or by employees assisting the partners*. Rev. Rul. 2004-3 adopts the position set forth in the Technical Explanations to more recent treaties, thereby clarifying the Service's position regarding this issue.

Former Limited Partner's Payment of Partnership Recourse Loan Was Partnership Income Under Section 61

In *MAS One Limited Partnership v. United States*, 271 F. Supp. 1061 (S. D. Oh 2003), the U.S. District Court for the Southern District of Ohio held that a former limited partner's repayment of the partnership's recourse debt was income to the partnership under Section 61 and not a capital contribution.

Facts

MAS One Limited Partnership ("MAS One") was originally formed for the purpose of owning and operating an office building known as the Barnett Bank Building. The sole general partner was MAS One Generals ("Generals"). The sole limited partner was the Midland Mutual Life Insurance Company ("Midland").

In 1989, MAS One amended its partnership agreement to expand its purpose to constructing and operating a second office building. To fund the expansion, MAS One borrowed $14.5 million (the "tower loan") from The Huntington National Bank (a recourse loan). As a recourse loan, Generals, as the general partner, would be liable for its repayment.

Generals' liability notwithstanding, Huntington required Midland to execute two guarantee agreements. The first required Midland to pay $2.5 million of the principal of the tower loan upon substantial completion of the office building. The second agreement required Midland to guarantee all interest payments for the life of the tower loan.

In 1994, for other business reasons, Midland sought to divest itself of its MAS One investment. Midland's guarantee of the interest payments, however, made it difficult for Midland to withdraw from the Partnership. Thus, Midland attempted to negotiate a release with Huntington. Ultimately, Midland's negotiations failed and Huntington refused to accept any of Midland's offers for terminating the guarantee. Midland, however, was determined to divest itself of its MAS One interest. Therefore, on December 28, 1994, Midland abandoned its interest in MAS One immediately after a new, nominal partner was admitted to the partnership as a limited partner (for a contribution of only $10). On December 29, 1994, MAS One sold the property for $4.1 million (paid to Huntington). Midland then paid Huntington $8.4 million, the remaining balance of the tower loan, even though it was not liable to repay the loan principal under its guarantees.

On its 1994 Form 1065, MAS One treated Midland's $8.4 million payment to Huntington as a capital contribution. MAS One also claimed a $7.3 million loss on the sale of the office building (allocating 98% to Generals and 2% to the new partner). The Service, however, disagreed and treated Midland's $8.4 million payment as partnership income under Section 61.

Analysis

MAS One argued that Midland's payment to Huntington in satisfaction of the tower loan was a capital contribution under Section 721(a) and not taxable income to the partnership. The Service, however, argued that because Midland was no longer a partner at the time it paid the $8.4 million to Huntington, the payment could not have been a contribution to the partnership. Rather than making the payment in exchange for a partnership interest, Midland made the payment as part of its effort to abandon its partnership interest. Therefore, the payment should be either income derived from business or discharge of indebtedness income, both of which are treated the same under Section 61(a).

MAS One argued that the payment was a contribution to capital because Midland committed to making the payment while it was still a partner. As such, Midland was "merely fulfilling its partnership obligations." The court, however, found that the payment constituted income to the partnership, not a capital contribution. For this conclusion, the court seemed to rely most heavily on the fact that (i) Midland's payment did not represent any amount it owed to MAS One and (ii) Midland did not acquire an additional or new interest in MAS One as a result of making the payment.

Ninth Circuit Affirms Bivens Decision Relief Not Available in TEFRA Case Against IRS Agents

In *Adams v. Johnson*, 355 F.3d 1179 (9th Cir. 2004), the Ninth Circuit affirmed U.S. District Court's (D. Ore.) dismissal of the plaintiffs' claims against Walter J. Hoyt III and more than twenty Internal Revenue Service agents for allegedly violating their rights to procedural due process, substantive due process, and conflict-free representation under the Fifth Amendment, and access to the courts under the First Amendment. The Ninth Circuit held that the plaintiffs failed to state a claim under the Supreme Court's ruling in *Bivens v. Six Unknown Named Agents of the Federal Bureau of Narcotics*, 403 U.S. 388 (1971), which held that government officials could be personally liable for violations, committed under the color of government authority, of citizens' constitutional rights.

Facts

Hoyt was a well-known sheep and cattle breeder who organized and sold, to investors, partnership interests in hundreds of investment partnerships that owned and raised livestock that Hoyt bred. The IRS accredited Hoyt as an enrolled agent. Thus, he was permitted to prepare federal income tax returns for the partnerships and represent the partners in dealings with the IRS. Hoyt was also the tax matters partner (TMP) for each partnership. Under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), a TMP is authorized to represent a partnership in all audit dealings with the IRS. In addition, in many instances the organization documents provide the TMP with the authority to file the partnership's tax returns.

Through the late 1970s, and continuing through the 1990s, the IRS audits of these partnerships concluded that they were all shams that were overvalued, that failed to substantiate tax items, and that lacked economic viability and profit motive. In early 1984, the IRS Criminal Investigation Division began investigating Hoyt's tax reporting on these partnerships. Hoyt was eventually indicted for bankruptcy fraud, mail fraud, and money laundering, but never for tax crimes. The plaintiffs (partners in the cattle partnerships) alleged that the IRS achieved success in these cattle partnership audits by exploiting Hoyt's conflict of interest in serving as TMP for the Hoyt partnerships while he was the subject of an IRS criminal investigation. The plaintiffs further alleged that, despite Hoyt's conflict, the federal defendants took no action to remove Hoyt as TMP, nor did they act to enjoin Hoyt's continued promotion of the partnerships or inform the plaintiffs that Hoyt was engaging in tax fraud. Thus, the plaintiffs contended that the federal defendants used the threat of their criminal investigation of Hoyt to gain concessions from Hoyt that facilitated the IRS's civil audits of the Hoyt partnerships, to the plaintiffs' detriment.

The plaintiffs, therefore, asserted claims for money damages under Bivens. They alleged that the IRS's audits of the partnerships and the IRS's assessment and collection of partnership taxes violated their rights to procedural due process, substantive due process, and conflict-free representation under the Fifth Amendment, and access to the courts under the First Amendment. The district court granted the defendants' motion to dismiss, concluding that the federal defendants were entitled to qualified immunity because of the court's view that the facts alleged in the complaint did not show any violation of a constitutional right. The plaintiffs appealed this ruling.

Analysis

In *Bivens*, the U.S. Supreme Court held that, in appropriate cases, government officials may be held personally liable for certain violations, committed under the color of government authority, of citizens' constitutional rights. *Bivens* gives an individual a federal common law basis to sue federal government officials if they violate the individual's constitutional rights. The Ninth Circuit noted, however, that precedent makes clear "the right to sue as established by *Bivens* is qualified and is not absolute." The Ninth Circuit further noted, "*Bivens* remedies are not available to compensate plaintiffs for all constitutional torts committed by federal officials."

In particular, the Ninth Circuit stated that other circuits addressing claims similar to those at issue in this case are nearly unanimous in holding that *Bivens* relief is not available for alleged constitutional violations by IRS officials involved in the process of assessing and collecting taxes. According to the Ninth Circuit, "The First, Third, Fifth, Sixth, Seventh, Eighth, and Tenth Circuits have all held *Bivens* actions inapplicable for claims arising from federal tax assessment or collection," relying on the comprehensiveness of the Internal Revenue Code, and the many explicit remedial provisions that the Code contains.

The extra-circuit case law notwithstanding, the Ninth Circuit stated that it could not discern any federal cases in any jurisdiction that have squarely addressed the specific question as to whether *Bivens* actions are precluded under TEFRA. The plaintiffs attempted to distinguish the extra-circuit case law by claiming that the rights granted to partners under TEFRA and TEFRA's remedial processes are different than those under the rest of the Internal Revenue Code. Specifically, the plaintiffs' argued that TEFRA limits partners' ability to protect their individual interests and to pursue remedies under the Internal Revenue Code.

The Ninth Circuit, however, rejected the plaintiffs attempt to distinguish TEFRA from the rest of the Internal Revenue Code. The Ninth Circuit's scrutiny of TEFRA revealed that TEFRA, like other parts of the Code, establishes a comprehensive scheme that streamlines the assessment and collection of partnership taxes, and ensures that individual partners retain meaningful opportunities to participate in partnership audits and litigation. Thus, the Ninth Circuit noted that TEFRA does not preempt many of the protections afforded to all taxpayers under other sections of the Code. For example, Section 7433, in general, permits taxpayers to recover damages from the government for intentional, reckless, or negligent disregard of the Code or regulations in connection with the collection of taxes. In addition, Section 7430 permits taxpayers to recover damages for audit positions taken by the IRS when such positions are not substantially justified. In sum, the Ninth Circuit stated that the remedies under TEFRA and other general provisions of the Code are adequate to provide a just remedy for any impropriety of government officials that may have occurred in the partnership audits and tax collection. Thus, the Ninth Circuit held that the plaintiffs in this case have no right to *Bivens* relief for any alleged unconstitutional actions of IRS agents engaged in tax audits and collection with regard to the cattle partnerships.

Trust Permitted to Take Charitable Deduction for its Distributive Share of Charitable Contribution Made by Partnership

In Revenue Ruling 2004-5, the IRS ruled that a trust is allowed to take a charitable deduction under Section 642(c) for its distributive share of a charitable contribution made by a partnership from the partnership's gross income, even though the trust's governing instrument does not authorize the trust to make such charitable contributions.

Facts

Under the facts of this revenue ruling, the governing instrument of a trust provides that all of the income is to be distributed annually to A for life. Upon A's death, the trust will terminate and all assets will pass to B. The trust's governing instrument does not authorize the trustee to make charitable contributions.

One of the trust's assets is an interest in a partnership. During the tax year, the partnership contributes cash from its gross income to a charitable organization for a purpose specified under Section 170(c). In computing its income tax, the trust takes into account its distributive share of the partnership's income, gain, loss, deductions (including charitable contributions), and credits. It is also important to note that none of the trust's income for the tax year is "unrelated business income" within the meaning of Section 681(a).

Analysis

The issue in this revenue ruling is whether a charitable deduction under Section 642(c) for a trust's distributive share of a charitable contribution made by a partnership from the partnership's gross income is prohibited because the trust's governing instrument does not authorize the trustee to make charitable contributions.

Section 642(c)(1) provides, in general, that a trust is allowed a deduction in computing its taxable income for any amount of the gross income that, under the terms of its governing instrument, is paid during the tax year for a purpose specified in Section 170(c). In addition, Section 702(a)(4) provides, in general, that in determining a partner's income tax, each partner must take into account that partner's distributive share of the partnership's charitable contributions. Further, Treas. Reg. Section 1.702-1(b) provides, in general, that the character, in the hands of a partner, of any item of income, gain, loss, deduction, or credit described in Section 702(a)(1)-(8) shall be determined as if that item were realized directly from the source from which realized by the partnership or incurred in the same manner as incurred by the partnership.

In order for a trust to claim a charitable deduction under Section 642(c) for amounts that it contributes for a charitable purpose, the trust's governing instrument must give the trustee authority to make such charitable contributions. In the case of a trust's investment in a partnership, such as described in this revenue ruling, the partnership can make a charitable contribution from its gross income, and that income is never available to the trust. The trust, however, for federal income tax purposes, must take into account its distributive share of the partnership's income, gain, loss, deductions, and credits. As such, the IRS ruled that a trust's deduction for its distributive share of a charitable contribution will not be disallowed under Section 642(c) simply because the trust's governing instrument does not authorize the trustee to make charitable contributions.

In this case, the partnership's charitable contribution is made from the partnership's gross income. The trust, therefore, is allowed a charitable deduction for its distributive share of this contribution even though its governing instrument does not authorize the trustee to make such contributions. In addition, because none of the trust's income for the tax year would be considered "unrelated business income" under Section 681(a), the amount of the charitable deduction is not limited under Section 681.

Partner Is Not Divested of Ownership Interest Until Date of Sale, Not Settlement Date

The Tax Court has held, in a memorandum opinion, that a partner retained such status for federal income tax purposes until a formal purchase agreement was entered into in 1990, and did not lose such status when a litigation settlement agreement was entered into in 1989. *Life Care Communities of America Ltd., et al. v. Commissioner*, T.C. Memo. 2004-5; No. 21683-94 (January 5, 2004)

Background

Robert McMichael, Hudson Fowler, and Raymond Smith formed a Florida corporation in 1981, FMS Properties Inc. (FMS), which developed a retirement center. FMS later became the sole general partner of a limited partnership, Life Care Communities of America, Ltd. (Life Care), formed by McMichael, Fowler, and Smith to share in the ownership and operation of the retirement center. They also formed Bentley Village, Inc. and Life Care Communities Management Corporation (management company) to share in the ownership and operation of the retirement center. McMichael was the managing partner of Life Care, president of FMS, vice president of the management company, and president of Bentley Village.

In 1985, Fowler and Smith removed McMichael from his managerial positions and excluded him from further business activities. They also transferred the contracts held by the management company to another entity controlled by them. McMichael filed a lawsuit in 1987 against Fowler and Smith, alleging embezzlement, conversion of assets, and civil theft.

Settlement Agreement

In 1989, they settled the lawsuit and as part of the settlement agreement McMichael received $200,000. To change the ownership in Life Care and other entities, the agreement provided the following options: (1) until September 30, 1989, McMichael could purchase Smith and Fowler's interests for $8 million; (2) before September 30, 1989, Smith and Fowler could terminate McMichael's option by purchasing his interest for $4 million; or (3) if McMichael did not exercise his option by September 30, 1989, then Fowler and Smith would have to purchase McMichael's interest for $2.4 million. In November 1989, Smith and Fowler informed McMichael that they would purchase his interest under the agreement. The 1989 agreement did not prohibit McMichael from participating in the Life Care's affairs.

Purchase Agreement

Fowler, Smith, and McMichael entered into a purchase agreement in 1990, providing for the transfer of McMichael's interest to Smith and Fowler for $2.6 million, which included the $200,000 previously paid to McMichael. Life Care issued Schedules K-1 to McMichael for his distributive share of partnership items for 1989 and 1990. McMichael excluded those items from his federal income tax returns after January 12, 1989.

IRS Position

In 1994, the IRS sent a Final Partnership Administrative Adjustment (FPAA) for 1989 and 1990 to Smith as the tax matters partner. The IRS also sent an FPAA to McMichael for 1989 and 1990, which determined that McMichael was divested of his ownership interest in Life Care in 1990, not 1989, and, therefore, he was a partner whose distributive share included partnership income accrued through the date of the purchase agreement. The IRS also determined that McMichael was liable for the income tax on his pro rata share of FMS and the management company's income. McMichael paid the income taxes on the FMS and management company income and filed a refund suit in district court. The district court entered judgment against McMichael, finding that McMichael was not divested of his ownership interest in FMS and the management company until 1990. The Eleventh Circuit affirmed the district court.

Tax Court Rationale

The Tax Court, agreeing with the IRS's determination, held that McMichael was not divested of his ownership interest until 1990 and that there was insufficient evidence to alter the construction of the unambiguous terms of the settlement agreement. McMichael noted that the partnership did not make any distributions to him after January 12, 1989, and, therefore, any allocation to him of partnership income lacked substantial economic effect. His arguments seemed to be the terms of the settlement agreement prohibited allocations to him of partnership items from having substantial economic effect under Section 704(b) because he could not have enjoyed the economic benefit of partnership allocations after entering into the settlement agreement, as the terms of the settlement agreement fixed the amount he was to receive for his partnership interest.

It is not clear if the court fully appreciated this argument. The court concluded that McMichaell failed to prove that the economic effect of the partnership's allocations were not substantial.

The court found that although Life Care did not make distributions to the partners in 1989 and 1990, the income was used to make payments relating to a $20 million loan. The court noted that under Section 752(b), Life Care was deemed to have made distributions to all of the partners liable for the loan, which included McMichael. He was liable for the loan at least until April 1990. Therefore, McMichael "received an economic benefit consistent with the underlying economic arrangement of the partners," according to the court.

PLR Provides That Second Closings and Forfeitures Did Not Cause Partnership to Fail the Fractions Rule

The IRS has ruled that changes in limited partners' percentage shares of partnership income and loss as a result of anticipated second closings and potential shifts due to forfeitures will not cause the limited partnership's tax allocations to fail to comply with the requirements of the fractions rule set out in Reg. Section 1.514(c)-2(b)(1)(i). PLR 200351032

Facts

A Section 501(c)(3) educational organization, classified under Sections 509(a)(1) and 170(b)(1)(A)(ii), plans to invest in a limited partnership (LP), which intends to invest in real property in the United States. The sole general partner of LP plans to raise a certain amount of capital from unrelated third-party investors through the private placement of limited partnership interests. LP will use the capital, in conjunction with borrowed funds, to acquire or improve real properties for investment. When prospective investors provide sufficient capital for LP to pursue its investment objectives, LP will admit the prospective investors as limited partners at an initial closing. The general partner and limited partners will enter into a limited partnership agreement, and interests in LP will be given to the investors in exchange for their commitments for capital contributions to LP.

If capital commitments fall short at the initial closing, LP will seek additional investors, who will be admitted as limited partners at a subsequent closings (i.e., a "second closing"). Separately, if a limited partner fails to timely fund its pro rata share of a capital call (i.e., a "forfeiture"), the general partner may make a default adjustment by decreasing the shares of overall partnership income and losses held by the defaulting limited partner, while increasing the shares of overall partnership income and losses held by non-defaulting limited partners.

Analysis

Dividends, interest, royalties, rent from real property, and gain from the sale of property (other than stock in trade or other property properly includible in inventory or property held primarily held for sale to customers in the ordinary course of trade or business) are generally excluded from unrelated business taxable income (UBTI) calculations (Section 512(b)). However, unless the "fractions rule" under Section 514(c)(9) is satisfied, debt-financed property will result in a portion of the income being treated as UBTI (Section 514). Specifically, a partnership meets the requirements of Section 514(c)(9)(E) if the allocation of items to a partner that is a qualified organization cannot result in the partner having a share of overall partnership income for any tax year greater than the partner's share of overall partnership loss for the tax year for which the partner's loss share will be the smallest (the "fractions rule"), and each partnership allocation has substantial economic effect within the meaning of Section 704(b)(2).

Ruling

The IRS concluded that, assuming that the allocations otherwise satisfied the requirements of the fractions rule, the changes in the limited partners' respective percentage shares of LP's overall partnership income and losses that would result from a second closing or forfeiture/default adjustment would not cause LP's tax allocations to fail to comply with the fractions rule. For LP's tax years following the initial closing but prior to the first subsequent closing or default adjustment, or after the subsequent closing or default adjustment but before the next subsequent closing or default adjustment, the Service also concluded that the fractions rule would apply to take into account only the partners' respective percentage shares of LP's overall partnership income and overall partnership loss during the same period of time.

ENDNOTES

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TEXAS PROPERTY TAX LAW DEVELOPMENTS

by John Brusniak, Jr.[1]

United States Courts of Appeals

TAX INJUNCTION ACT BARS SUIT IN FEDERAL COURT CHALLENGING CONSTITUTIONALITY OF RETROACTIVE PROPERTY TAX COLLECTION PENALTY.

Washington v. Linebarger, Goggan, Blair, Pena & Sampson, LLP, 338 F.3d 442 (5th Cir. 2003).

The City of New Orleans implemented a 30% retroactive delinquent property tax collection penalty payable to the attorneys representing the city in its collection efforts. A class action suit was filed in United States District Court challenging the constitutionality of the retroactive penalty. The federal district court dismissed the suit on jurisdictional grounds due to the Tax Injunction Act, and the taxpayers appealed. The appellate court upheld the dismissal, ruling that neither of the exceptions to the Tax Injunction Act had been established by the taxpayers. Contrary to the taxpayers' assertion, the court held that the penalty assessed was so inextricably intertwined with the tax assessment as to constitute a tax, and not a challengeable fee. It further ruled that the taxpayers had adequate remedies available to them in the state court, notwithstanding the significant procedural and substantive obstacles set forth in Louisiana law.

Texas Supreme Court

A STATE PROPERTY TAX CAN EXIST EVEN IF ONLY ONE OR A FEW TAXING DISTRICTS ARE IMPACTED; A STATE PROPERTY TAX IS CREATED WHEN A TAXING UNIT IS DENIED MEANINGFUL DISCRETION IN THE RATE SETTING PROCESS.

West Orange-Cove Consolidated Independent School District v. Alanis, 107 S.W.3d 558 (Tex. 2003).

Several school districts filed suit against the State of Texas alleging that the statutory scheme of utilizing *ad valorem* taxation to fund public education had resulted in the creation of an unconstitutional state property tax. The trial court dismissed the suit, ruling that the pleadings failed to state a viable cause of action. The Texas Supreme Court reversed, ruling that (1) a property tax could be deemed to be a state property tax even if it did not have state-wide effect, but only affected one or a few school districts; (2) that the constitutional prohibition against a state property tax would be violated whenever the state exercised such control over the taxing process as to deny a taxing authority "meaningful discretion" in setting its tax rates; (3) that the state was required to prove that school districts were not forced to tax at maximum rates to meet either state accreditation standards or the constitutional mandate of providing a general diffusion of knowledge; (4) that the school districts were entitled to prove that the existence of homestead exemptions did not afford them meaningful discretion in setting their tax rates; and (5) that the fact that the school districts were not actually taxing at the maximum rate of $1.50 per $100 of value did not necessarily prove that the school districts had meaningful discretion in setting their tax rates.

Texas Courts of Appeals

TRIAL COURT MAY BLEND MARKET APPROACH, COST APPROACH AND INCOME APPROACH TO DETERMINE MARKET VALUE OF PROPERTY.

Houston R.E. Income Properties XV, Ltd. v. Waller County Appraisal District, No. 01-02-00665-CV (Tex. App. –Houston [1st Dist.] December 18, 2003, no pet. h.). (to be published).

In trial of market value of an income producing property, the court indicated that it would blend the market approach testimony with the income approach testimony to determine the market value of the property. Dissatisfied with the court's determination, taxpayer appealed the result claiming that blending valuation techniques was improper, and that the court was required to rely exclusively on either the market, cost or income approaches to valuation. The appellate court disagreed finding that the blended result produced a relevant and reliable indication of the property's market value.

Texas Attorney General Opinions

PROCEDURAL ASPECTS OF TAX WARRANTS FOR REAL AND PERSONAL PROPERTY.

Op. Tex. Att'y Gen. GA-0140 (2004).

Tax warrants for delinquent personal property taxes may be served and executed by any peace officer authorized in Section 2.12 of the Texas Code of Criminal Procedure. Tax warrants for delinquent real property taxes may be served and executed only the sheriff or constable. Seizure of the property requires the officer executing the warrant to take possession or control of the property in such a fashion as to interfere with the owner's possessory interest in the property. Unless the terms of the tax warrant direct otherwise, a peace officer is not required to turn over seized personal property to the tax assessor; however, the peace officer elect to do so. A peace officer is required to turn over seized real property to the tax assessor. A peace officer seizing personal property is required to prepare an inventory of the seized property. Except in counties with a population in excess of 3,000,000, seized personal property may only be sold by a peace officer. In counties with a population in excess of 3,000,000, seized personal property may be sold by either the peace officer or tax assessor as specified in the tax warrant. In such counties, the property may be sold by an auctioneer or internet service provider. Seized real property may be sold by either a peace officer or tax assessor as directed by the tax warrant. Seized real property must be sold on the first Tuesday of the month at the courthouse door between the hours of 10:00 a.m. and 4:00 p.m. Seized personal property may be sold at any time unless the tax warrant directs otherwise. The Tax Code provisions authorizing the tax assessor to sell seized property are constitutional.

PRIVATE ROADS SUBJECT TO A PUBLIC EASEMENT, WHOSE DEDICATION TO THE GOVERNMENT HAS NOT BEEN ACCEPTED, ARE TAXABLE.

Op. Tex. Att'y Gen. GA-0139 (2004).

A privately owned road, which is subject to a public easement, but whose dedication for public purpose has not been accepted by the government is taxable. Only publically-owned roads are exempt from taxation.

THE TERMS OF A TAX ABATEMENT AGREEMENT MAY NOT BE RETROACTIVELY AMENDED SO AS TO REDUCE A TAX WHICH HAS BEEN ASSESSED.

Op. Tex. Att'y Gen. GA-0134 (2004).

The government may not retroactively amend a tax abatement agreement to qualify property for exemption. Exemption qualifications are determined as of January 1 of the tax year in question and *post facto* alterations of the qualifications are not contemplated by the statute. Additionally, altering an abatement agreement after taxes have been assessed violates the prohibition in Article III, section 55 of the Texas Constitution against releasing or extinguishing taxes.

ENDNOTES

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TAX CONTROVERSY: RECENT CRIMINAL TAX DEVELOPMENTS

by Josh O. Ungerman[1]

1. United States District Court for the Southern District of New York grants motion for downward departure and departs seven levels.

U.S.A. v. Greene, U.S. Dist. Ct. for the Southern District of New York, 2003 US Dist. LEXIS 371 (January 13, 2003).

The defendant pled guilty to thirteen counts of aiding and assisting in the preparation of false income tax returns in violation of § 7206. The defendant's original sentencing range was between eighteen and twenty-four months. The defendant filed a motion for downward departure based upon his extraordinary history of charitable work and community service combined with his extraordinary family circumstances. The court granted the defendant's motion for downward departure and emphasized three points.

First, the defendant was the sole provider of both financial and emotional support for his three sons. Accordingly, any period of incarceration risked causing grievous harm to the defendant's particularly vulnerable children. A sentence involving imprisonment would cause his sons to, at least temporarily, again be placed in foster care. In light of the children's histories, an additional placement in foster care, according to the court, would destroy the stability the children had achieved with their father.

Second, the court found its sentence of probation along with an order of restitution was sufficient to serve the dual aims of deterrence and retribution.

Third, the court found it was highly unlikely that the defendant would repeat his criminal conduct in light of the fact that he was sixty-five years old and previously had no criminal history points. The court departed downward seven levels to a level eight which included a sentencing range of zero to six months. The court sentenced the defendant to three years of probation and restitution.

2. Defendant's motion in limine granted against Government's attempt to include tax count conduct in mail fraud indictment after severance.

U.S. v. Huffine, U.S. Dist. Ct. for the Eastern District of Louisiana, 2003 U.S. Dist. LEXIS 583 (January 13, 2003).

Even though the Opinion addresses mail fraud counts, this is a good case because it illustrates the opportunities for severance relating to mail fraud and tax counts in addition to a motion in limine when the government attempts to bring in evidence which would be used in the tax counts in the severed mail fraud counts. The defendant was originally charged with four counts of mail fraud in violation of 18 U.S.C. §§ 1341 and 1342 and six counts of tax evasion in violation of 18 U.S.C. § 2 and I.R.C. §§ 7202 and 7206.

The original indictment alleged that the defendant, through his construction company, created a scheme to defraud the school board by fraudulently obtaining payments through the submission of inflated payment invoices. The original indictment did not allege that part of the defendant's scheme was to use the fraudulently obtained funds for his personal use. The court granted the defendant's motion to sever the mail fraud and tax evasion offenses because the indictment failed to allege sufficient commonality between the defendant's underlying acts with respect to the mail fraud counts and the tax evasion counts. The court, in granting the severance, noted that the government failed to specifically allege what role, if any, the income derived through the alleged mail fraud scheme played in the tax evasion charges.

The government responded by obtaining two separate superseding indictments which split the mail fraud counts and the tax evasion counts. The government alleged in the superseding indictment relating to the mail fraud counts that the defendant's scheme was to defraud the school board with the intention of using the fraudulently obtained funds for personal use. The government planned to use evidence of the defendant's alleged expenditures of corporate funds, including those alleged to have been fraudulently obtained from the school district, for the defendant's personal expenses. The defendant filed a motion in limine to keep the evidence of his expenditures of corporate funds for personal expenses out of the mail fraud trial.

The basis for defendant's motion in limine was that the evidence was irrelevant under Fed. R. Evid. 401 and 402 and that the evidence was also unduly prejudicial, confusing and misleading under Fed. R. Evid. 403. The court found that while the evidence would be marginally relevant, under Rules 401 and 402, the evidence would be inadmissible under Rule 403. The court found that with respect to the government's purported evidence of the defendant's alleged use of corporate funds for personal expenses that the jury may be persuaded to convict the defendant because it believes that it is illegal to use corporate funds to pay personal expenditures even though the owner of a corporation is entitled to pay personal expenses without necessarily committing a crime.

3. Fourth Circuit rejects tax preparer's argument that taxpayer/clients who testified at trial committed perjury rendering the trial unfair.

U.S. v. Jennings, United States Court of Appeal for the Fourth Circuit, 2002-2, U.S. Tax Cases (CCH), November 14, 2002 (unpublished).

The Appellant, a tax preparer, was convicted of willfully aiding or assisting in the preparation or presentation of false and fraudulent returns in violation of § 7206(2). At trial, the government used the taxpayer/clients of the tax preparer in its case in chief.

The taxpayer/client witnesses signed returns under penalty of perjury but testified at trial that they did not review the returns and were not aware of the fraudulent deductions. The Appellant argued that the Appellant was deprived of a fair trial because the government used the perjured testimony of the taxpayer/client witnesses. According to the Appellant, the taxpayer/client witnesses committed perjury either when the returns were signed or when they testified. The Fourth Circuit rejected this argument and held that regardless of whether the government knowingly used perjured testimony, there was no reasonable likelihood that the false testimony affected the judgment of the jury. The Fourth Circuit concluded that the weight of the evidence strongly supported the finding of guilt without the taxpayer/client witnesses' testimony because the deductions claimed on the returns were so grossly disproportionate to the taxpayer/client witnesses' income.

4. **Amendment to Fed. R. Crim. P. 33 held not to violate the Ex Post Facto Clause.**

U.S. v. Ristovski, 312 F.3rd 206 (6th Cir., December 4, 2002).

The Appellant was convicted by a jury in district court for subscribing to false corporate tax returns and submitting false documents to the Internal Revenue Service. The defendant filed a motion for new trial on the basis of newly discovered evidence which the district court denied as untimely.

The prior version of Fed. R. Crim. P. 33 required that motions for a new trial based on newly discovered evidence be brought within two years after final judgment. Based upon this prior version of the rule, defendant's motion for new trial would have been timely. In 1998, Fed. R. Crim. P. 33 was amended to require motions for new trial based on newly discovered evidence be brought within three years after the verdict or a finding of guilt. Thus, the district court held and the appellate court upheld that the Appellant's motion for new trial was untimely under the 1998 Amendment to Fed. R. Crim. P. 33.

The appellate court found that holding the defendant's motion for new trial as untimely under the Amended Fed. R. Crim. P. 33 did not violate the Ex Post Facto Clause. The appellate court held that the retroactive application of amended Fed. R. Crim. P. 33 was not a violation of the Ex Post Facto Clause because the application of the time limitation merely changed the mode of procedure. The appellate court held that the amended rule did not assign more disadvantageous criminal or penal consequences to the appellant's actions than did the law in place when the actions occurred. Additionally, the appellate court held that the amendment did not affect matters of substance or alter any substantial personal rights of the appellant.

5. **Magistrate judge's discovery disclosure order reversed as being to overreaching.**

U.S. v. Mehta, United States District Court for the District of Massachusetts, 2002 U.S. Dist. LEXIS 24855, (December 31, 2002).

The defendant was charged with tax evasion and mail fraud. The indictment alleged that the defendant understated his business gross sales in both his tax returns and his franchise reports provided to his franchisor. After the government made its expert tax witness disclosure pursuant to Fed. R. Crim. P. 16(a)(1)(E), the defendant made a reciprocal disclosure pursuant to Fed. R. Crim. P. 16(b)(1)(C). Rule 16(b)(1)(C) requires reciprocal disclosure of (1) the expert witness' opinions, (2) the basis for those opinions, and (3) the expert's qualifications.

After the government complained about the defendant's disclosures, he supplemented his disclosures. Nonetheless, the dispute eventually resulted in the magistrate judge issuing an order requiring "if the expert is going to testify that any items, which the government claims were income to the defendant, were not, in his opinion, income to the defendant, he shall list each item and explain why he is of the opinion that the items were not income and thus not properly included in the income which the defendant did report."

The district court reversed the magistrate judge's order and held that to require the defendant's tax expert to disclose why he challenges each purported line of income, which basically calls for a line-by-line disclosure, would be to impose a requirement not for an expert summary, but effectively for an expert deposition. Thus, the district court reversed the magistrate's order. This case also includes an interesting discussion of the difference between civil and criminal discovery.

6. **Bureau of Prisons silently eliminates community confinement for defendants sentenced in Zone C or Zone D.**

On December 13, 2002 the Department of Justice Office of Legal Counsel issued a memorandum addressing the practice of placing low risk non-violent offenders with a short sentence of imprisonment into a community confinement option rather than prison. The Department of Justice memorandum concludes that federal courts violate the U.S. Sentencing Guidelines when they order a defendant sentenced to Zone C or Zone D to serve the sentence in community confinement or a defendant sentenced to a Zone C split sentence to serve the imprisonment portion of the sentence in community confinement. Not surprisingly, the Department of Justice concluded that the Bureau of Prisons lacked the same authority. This is already a hotly contested issue as the Bureau of Prisons has gone so far as to yank people out of community confinement and throw them into a prison institution.

7. **New changes in Voluntary Disclosure Policy combined with the Offshore Voluntary Compliance Initiative announced in Rev. Proc. 2003-11 provide new opportunities for voluntary disclosures.**

The timeliness of a voluntary disclosure is an issue which has challenged practitioners for quite a while. This is especially true in light of the Internal Revenue Service's recent pronouncements with respect to the offshore credit card initiative. Practitioners complained that they have clients ready to participate in the voluntary disclosure program but are unsure if a voluntary disclosure would be applicable due to the recent publicity issued by the Internal Revenue Service on the offshore credit card initiative.

To address many of these concerns the Internal Revenue Service has revised their voluntary disclosure policy to provide that a voluntary disclosure is timely if it is received before: (1) The IRS has initiated a civil examination or criminal investigation of the taxpayer, or has notified the taxpayer that it intends to commence an examination or investigation; (2) The IRS has received information from a third party (e.g., informant, other governmental agency, or the media) alerting the IRS to the specific taxpayer's noncompliance; (3) The IRS has initiated a civil examination or criminal investigation which is directly related to the specific liability of the taxpayer; or (4) The IRS has acquired information directly related to the specific liability of the taxpayer from a criminal enforcement action (e.g., search warrant, grand jury subpoena).

The following example from the manual addressing the timely issue of voluntary disclosures is most instructive:

> A disclosure made by a taxpayer of omitted income facilitated through a widely promoted scheme regarding which the IRS has begun a civil compliance project and already obtained information which might lead to an examination of the taxpayer; however, the IRS has not yet commenced an examination or investigation of the taxpayer or notified the taxpayer of its intent to do so. In addition, the taxpayer files complete and accurate returns and makes arrangements with the IRS to pay in full, the tax, interest, and any penalties determined by the IRS to be applicable. This is a voluntary disclosure because the civil compliance project involving a scheme does not yet directly relate to the specific liability of the taxpayer and because all the other elements for a voluntary disclosure are met.

The above example is helpful in relation to offshore credit cards. In addition to the above example, the Internal Revenue Service announced in Rev. Proc. 2003-11 the offshore voluntary compliance initiative with regard to offshore accounts. Taxpayers had until **April 15, 2003** to provide a voluntary disclosure to the Internal Revenue Service identifying themselves and the promoters involved in their case if they want to take advantage of the offshore voluntary compliance initiative which some are calling partial amnesty. Taxpayers who participated were required to pay back-taxes, interest, delinquency and accuracy related penalties. The Internal Revenue Service did not impose fraudulent failure to file and information return civil penalties. Additionally, the Financial Crimes Enforcement Network (FINCEN) did not impose civil penalties on the failure to file the report of foreign bank and financial accounts (FBAR). As with the voluntary disclosure program, the Internal Revenue Service did not promise that no criminal prosecution would occur but rather it remained a factor to be considered. Practically, it is extremely unlikely that a taxpayer who complied with Rev. Proc. 2003-11 prior to the April 15, 2003 deadline would find themselves the target of a criminal prosecution by the Internal Revenue Service.

The new Voluntary Disclosure Policy also provides guidance with respect to unfiled returns after a taxpayer has received a notice stating that the Internal Revenue Service has no record of receiving a particular return and inquiring into whether the taxpayer filed a return for that year. The new Voluntary Disclosure Policy notes that even with these notices, a voluntary disclosure can occur because the Internal Revenue Service has not yet commenced an examination or investigation of the taxpayer or notified the taxpayer of its intent to do so.

ENDNOTE

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TAX-EXEMPT ORGANIZATIONS: RECENT DEVELOPMENTS

by Tyree Collier[1]

The following is a summary of selected current developments in the law applicable to tax-exempt organizations, prepared by Tyree Collier, Chair of the Tax-Exempt Organizations Committee of the Section of Taxation. Unless otherwise indicated, all section references contained herein are references to the Internal Revenue Code of 1986, as amended (the "Code").[2]

A. LITIGATION

1. St. David's wins federal jury trial to preserve Section 501(c)(3) exemption in whole-hospital joint venture case. St. David's Health Care System, Inc. won a major victory against the Service when a federal jury reached a verdict on March 4 that St. David's had not ceded control of its assets and operations to its for-profit partner in a whole-hospital joint venture.[3] The jury's decision should bring an end to this important case where the advantage has swung back and forth between St. David's and the Service.

   St. David's is a 501(c)(3) organization that formerly owned and operated nonprofit hospitals in Austin, Texas. In 1996, St. David's entered into a whole-hospital joint venture with a for-profit partner whereby both parties contributed their hospitals and related assets to the joint venture. After the effective date of the agreement, St. David's primary operation was to serve as a partner in that joint venture. The Service revoked St. David's 501(c)(3) exemption in October 2000 primarily because the agreement between St. David's and its partner did not give St. David's the right to select a majority of the members of the governing body and also, according to the Service, did not give St. David's control over the day-to-day operations. The Service's revenue ruling on whole-hospital joint ventures, Revenue Ruling 98-15, has been interpreted as requiring that the exempt partner in a joint venture with a for-profit partner have the ability to select a majority of the members of the governing body and also maintain control over the day-to-day operations.

   The district judge granted summary judgment to St. David's in June 2002 in a strongly-worded opinion that rejected the Service's position that the tax-exempt partner had to maintain absolute control over a joint venture with a for-profit partner in order for the venture to be regarded as an exempt activity. The district judge relied on other protections in the joint venture documents that were designed to ensure that the venture's activities and operations complied with the requirements for charitable operations under Section 501(c)(3). The district court's ruling concluded that the venture's operations were charitable within the meaning of Section 501(c)(3) and was generally regarded as a rejection of the Service's position on the issue as set forth in Revenue Ruling 98-15.

Then, in November 2003, the Fifth Circuit vacated and remanded the district court judgment.[4] The Fifth Circuit held that it was not sufficient for St. David's to show simply that the venture provides some or an extensive amount of charitable care. Rather, St. David's must also show that the venture does not substantially further non-charitable purposes. To do that, St. David's had to show that private individuals and for-profit entities did not have either formal or effective control over the venture. The Fifth Circuit remanded the case for the district court to decide whether St. David's ceded control to its for-profit partner. In doing so, the Fifth Circuit discussed numerous factors that it viewed as indicating that St. David's may have ceded control.

Despite the Fifth Circuit opinion that strongly supported the Service's position, the issue of control was a fact issue and thus allowed for the federal jury to find that control had not been ceded to the for-profit partner. Going forward, the Service's position as set forth in Revenue Ruling 98-15 remains largely intact, except that there will be no per se requirement (at least in Fifth Circuit states) that the exempt organization select a majority of the members of the governing body. However, exempt organizations that have entered into joint ventures with for-profit partners should feel somewhat encouraged. Because the issue of control is ultimately a fact issue, organizations that can marshal an attractive case (such as the support St. David's received from the City of Austin in its case) should have a good chance of convincing a jury that they have not ceded control. Nevertheless, that factor may be more important in situations involving ancillary joint ventures given that few organizations will want to bet their exemption by going before a jury, even with an appealing case.

B. REGULATIONS, IRS RULINGS, PROPOSED LEGISLATION, ETC.

1. Revenue Ruling 2004-6 (Service provides examples of public policy advocacy that constitute political activities). The ruling summarizes the rules applicable to public advocacy by organizations exempt from federal income tax under Sections 501(c)(4), 501(c)(5), and 501(c)(6). The ruling notes that such organizations may engage in public advocacy of public policy issues, including lobbying for or against legislation, either as part of their exempt purpose or as activities that do not constitute their primary activities. It notes, however, that such advocacy may constitute an "exempt function" under Section 527(e)(2). An "exempt function" under Section 527(e)(2) is essentially a political activity and is defined generally as influencing or attempting to influence the selection, nomination, election, or appointment of any individual to any federal, state, or local public office. Under Section 527(f)(1), an exempt organization that engages in an activity that is an "exempt function" is subject to tax on the lesser of its investment income or the amount expended on the "exempt function" activity, assuming that the exempt organization did not conduct the activity through a "segregated fund" that is treated as a separate entity under Section 527.

   The ruling explains that all facts and circumstances must be considered to determine whether an expenditure for an advocacy communication is for an "exempt function" under Section 527(e)(2). The ruling identifies six factors that tend to indicate an advocacy communication is an exempt function, including that the communication identifies a candidate, coincides with a campaign, targets voters, identifies a candidate's position, addresses an issue that is known as an issue setting a particular candidate apart, or is not part of an ongoing series of substantially similar communications. The ruling also identifies several factors that tend to indicate an advocacy communication is not an "exempt function," including that the communication identifies specific legislation or a specific event the organization hopes to influence, that its timing coincides with an event outside the control of the organization, that it identifies a candidate solely as a government official in position to act on the issue, or that it identifies the candidate solely as a sponsor of the communication. The ruling concludes by discussing in detail the facts and circumstances of six potential scenarios and deciding whether or not the advocacy in each scenario is an "exempt function" activity.

2. Service publishes CPE article on fraternal organizations. The Service's new CPE article on fraternal organizations, available on the IRS web site, explains the tax requirements for organizations exempt under Sections 501(c)(8) and 501(c)(10). Fraternal organizations exempt under Section 501(c)(8) must provide insurance-type benefits to their members, while organizations exempt under Section 501(c)(10) are prohibited from providing such benefits and must operate exclusively for religious, charitable, scientific, literary, educational, and fraternal purposes. While not providing new law, the article serves as a good summary of the requirements applicable to exempt fraternal organizations.

3. Notice 2004-7 (Service to carefully scrutinize charitable contributions of intellectual property). The Service formally announced in this Notice that it is carefully scrutinizing charitable contributions that are taken for contributions of intellectual property and will be reviewing organizations that have promoted transactions where improper deductions have been taken. The Service explained that it has noticed excessive deductions being taken in situations where the contribution is of a nondeductible partial interest, where the valuation does not consider an expectation of receipt of benefits in exchange for the transfer, where there is inadequate substantiation of the contribution, and where there is just a simple overvaluation of the intellectual property. The Service noted that it is seeing an increasing number of donations that "do not pass the smell test" and that it may in some cases impose penalties on the organization claiming the deduction and on promoters and appraisers as well.

4. Notice 2004-12 (Service attempts to limit student FICA exception). In this Notice, and related proposed regulations under Section 3121(b)(10) (see 69 Fed. Reg. 8604), the Service attempts to limit the

FICA exception for students at a school, college, or university by requiring that the employer be an institution whose primary activity is the provision of educational activities. Thus, according to the Service, medical residents at a teaching hospital cannot qualify for the student FICA exception if the hospital's primary activity is to care for patients. The Service also takes the position that an employee who regularly works 40 or more hours per week is a career employee and is ineligible for the student FICA exception. This issue is not entirely new, as the Service has made this argument in court, including in a 2003 district court case where the court recently rejected the Service's position.[5]

5. House Ways and Means Committee to review tax-exemptions for nonprofit hospitals. Committee Chairman William Thomas announced on March 2 that the Committee would examine what nonprofit hospitals do to deserve tax-exempt status under Section 501(c)(3). Thomas referenced a December 2003 letter from the American Hospital Association to the Department of Health and Human Services regarding the ability of hospitals to give price breaks to uninsured patients. While Thomas said he had been thinking about re-examining tax exemptions for nonprofit hospitals for some time, he characterized the December 2003 letter from the AHA as both "scary" and "cynical." Thomas said that nonprofit hospitals should serve the community in some way in order to earn their tax exemptions, but that an informal review had revealed that it was difficult to discern between for-profit and nonprofit hospitals. Thomas claimed that removing the tax-exempt status of nonprofit hospitals could create an enormous area of potential revenue for the federal government. Thomas made his announcement while speaking at the annual meeting of an association of for-profit hospitals, and thus has the appearance of a purely political ploy. While it seems unlikely that the examination will result in any significant changes, the examination could actually provide an opportunity for nonprofit hospitals to present a public case justifying their federal tax exemptions.

END NOTES

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

2 The term "Service" refers to the Internal Revenue Service.

3 *St. David's Health Care System Inc. v. United States*, W.D. Tex., No. 101CV-046 (3/4/04).

4 *St. David's Health Care System v. U.S.*, 92 A.F.T.R. 2d 2003-6865 (5th 2003).

5 *United States v. Mayo Foundation for Medical Education and Research*, D Minn., No. 01-1121; 12 HLR 1282 (8/14/03).

ENERGY AND NATURAL RESOURCES:RECENT DEVELOPMENTS

by Mary A. McNulty[1]

The following is a summary of the recently proposed energy bill, the Energy Tax Incentives Act of 2004. The summary focuses on federal tax law. It has been prepared by Mary A. McNulty, Chair of the Energy and Natural Resources Committee and a partner at Thompson & Knight LLP, and Janet P. Jardin,[2] an associate at Thompson & Knight LLP, as a project of the Energy and Natural Resources Tax Committee. Unless otherwise indicated, all Section references are to the Internal Revenue Code of 1986, as amended (the "Code").

A. The "Old" Energy Policy Act of 2003

As reported in the last current developments article, Congress abandoned efforts to pass the Energy Policy Act of 2003 (H.R. 6). The legislation would have provided approximately $23.5 billion in tax breaks without any revenue offsets. The bill was aimed at encouraging conservation, domestic production, and reliability improvements. In addition, it would have extended a number of energy tax provisions that were set to expire on December 31, 2003.

B. The "New" Energy Tax Incentives Act of 2004

On February 12, 2004, the Energy Tax Incentives Act of 2004 (S. 2095) was introduced and read for the first time in the Senate. The energy bill is sponsored by Senate Energy and Natural Resources Chairman Pete V. Domenici (R-N.M.). This is the third time that Congress has tried to pass energy legislation.

On March 5, Senate Finance Committee Chairman Chuck Grassley (R-Iowa) offered a second-degree amendment to the bill that would generally extend by one year several tax provisions that have expired or would have expired. Four of those tax provisions are included in the new energy bill.

The Energy Tax Incentives Act of 2004 varies only slightly from the tax title reported out of the Finance Committee in May 2003. Although neither the Congressional Budget Office nor the Joint Committee on Taxation has released an official "score" (or estimate of the cost to the federal government), the new energy bill is expected to score at 45 percent of the cost of the old energy bill (approximately $14 billion) without forfeiting most of the goals of the old bill. The principal difference between the old bill and the new bill is that the current proposal has later effective dates, which in most cases is October 1, 2004, and denies certain Alternative Minimum Tax ("AMT") relief. Some of the key tax changes and Senator Grassley's proposed amendments are discussed below.

C. Oil and Gas Provisions

The new energy bill differs from the old bill's conference report in the following respects: (1) there is no AMT relief for intangible drilling costs, gas gathering lines, and distribution lines; (2) there are more limited Section 29 credits for existing facilities; (3) the Section 29 credit is not a general business credit; (4) there is no suspension of the percentage depletion limitation of 65 percent of taxable income; and (5) there is an Alaska natural gas production tax credit.

In the last current developments article, we reported that the circuit courts remained split as to whether gas gathering pipelines are subject to a 7-year or a 15-year recovery period. The new energy bill establishes a 7-year recovery period and a 14-year class life for natural gas gathering lines. It also establishes a 15-year recovery period and a 35-year class life for natural gas distribution lines.

The new energy bill modifies the Section 29 tax credit for fuels from nonconventional sources in numerous respects. It expands the categories of fuels for which the credit is available by adding viscous oil, refined coal, coalmine gas, and agricultural waste. Also, it would make the Section 29 credit available for qualifying liquid, gaseous, or solid synthetic fuels produced from coal for facilities placed in service October 1, 2004 through December 31, 2006. The energy bill provides a 3-year placed-in-service window for new wells for all qualified fuels except synthetic fuels from coal, which must meet new requirements. The amount of the credit is set at $3/barrel (or Btu equivalent) and is not adjusted for inflation. Most production is capped at a 200,000 cubic feet daily average. The Section 29 credit is reinstated and extended for certain qualified fuels produced and sold before January 1, 2006 from existing wells placed in service after December 31, 1979 and before January 1, 1993. This extension applies only to wells that produce coke, coke gas, or natural gas and byproducts produced by coal gasification from lignite. Furthermore, the 200,000 cubic feet cap does not apply to such production.

The new energy bill contains special incentives for Alaska natural gas. First, it allows a credit per million Btu of natural gas for Alaska natural gas entering a pipeline during the 15-year period beginning the later of January 1, 2010, or the initial date for the interstate transportation of Alaska natural gas. The credit may be claimed against both the regular income tax and the AMT. The maximum monthly credit amount is $0.52/million Btu (indexed for inflation). The credit is phased out beginning when the price at the wellhead exceeds $0.83/million Btu until it exceeds $1.35/million Btu (indexed for inflation), at which point the credit is not available. Second, the energy bill establishes a 7-year recovery period and a 10-year class life for Alaska gathering lines. Third, the energy bill provides for an investment credit for Alaska gas treatment facilities.

D. Section 45 Credits for Renewable Electricity Production

Section 45 of the Code provides for a credit against income tax for renewable electricity production. The new energy bill expands the types of energy resources for which the Section 45 credit is available. In addition to wind, closed-loop biomass, and poultry waste, the energy bill would allow the credit for other than closed-loop biomass, geothermal energy, solar energy, small irrigation power, biosolids and sludge, and municipal solid waste.

The new energy bill differs from the old bill (as reported in conference) in the following respects: (1) there is no inflation adjustment; (2) there is no AMT relief; (3) there is no credit for electricity produced from landfill gas; and (4) certain credit rates and durations were scaled back, as discussed in the following paragraph.

The new energy bill generally increases the Section 45 credit from $0.015/kWh of electricity to $0.018/kWh but reduces the period for which the credit is available from 10 years to 5 years after the qualifying facility is placed in service in certain circumstances. The energy bill expands the placed-in-service window for wind from December 31, 2003 to December 31, 2006. The placed-in-service window for the new energy resources is from the date of enactment of the Energy Tax Incentives Act through December 31, 2006. Special rules apply to biomass other than agricultural waste.

Senator Grassley's amendment would extend the placed-in-service date under current Section 45 to include qualified facilities placed in service before January 1, 2005.

E. Alternative Motor Vehicles and Fuel Incentives

The new energy bill contains several alternative vehicles and fuels provisions that were deleted from the old bill in conference, including a new tax credit for electric vehicles, a retail credit for alternative fuels, and a credit for investments in alternative fuel equipment. The new energy bill allows a tax credit for the following four types of advanced technology vehicles: (1) hybrid vehicles, (2) alternative fuel motor vehicles, (3) full cell motor vehicles, and (4) electric motor vehicles. Electric vehicles are eligible for a current credit, which is increased and extended under the new bill from 2004 to 2006. In general, the credit amount is computed by adding a base credit for achieving a particular technology and an additional credit for achieving certain improvements in fuel economy. All vehicles would need to meet minimum emissions standards to qualify.

A general description of the various types of advanced technology vehicles and their respective base and additional credit ranges are set forth in the chart below.

TYPE OF VEHICLE	DESCRIPTION	BASE CREDIT RANGE	BONUS CREDIT RANGE
HYBRID	Runs partially on a rechargeable energy storage system and partially on an internal combustion engine	$100-$400 (light duty/ passenger) $1,000-$10,000 (heavy duty)	$500-$3,000 (light duty/passenger) $1,500-$12,000 (heavy duty)
ALTERNATIVE FUEL	Runs exclusively on natural gas, liquified natural gas, ethanol, methanol, and liquified propane gas	40% of incremental cost over cost when fitted as a petroleum fuel vehicle	30% of incremental cost if meets most stringent emissions (other than zero) classification
FUEL CELL	Uses hydrogen fuel to generate electricity; has zero emissions; and its only byproduct is water	$4,000 (light duty/passenger) $10,000-$40,000 (heavy duty)	$1,000-$4,000 (light duty/passenger) None for heavy duty
ELECTRIC	Runs on batteries and "plug in"; does not recharge on its own like hybrids	$3,500 Lesser of 10% of cost or $1,500 (low-speed)	If capable of driving over 100 miles on a single charge

Senator Grassley's amendment would stick with the current 10 percent (maximum $4,000) nonrefundable credit available to buyers of qualified electric vehicles, but it would eliminate the scheduled phase out between 2004 and 2006.

F. <u>Conservation and Energy Efficiency</u>

In all respects (except one), the new energy bill is broader than the conference report of the old bill for conservation and energy efficiency as it contains certain provisions that were either struck or reduced in conference. The new energy bill contains a credit for energy-efficient heating and cooling equipment, a credit for microturbines, and a deduction for commercial buildings, which were all defeated in Congress. The bill also contains the full credit for residential buildings, the 30 percent credit for wind and fuel cells, the full credit for appliances, and the full deduction for commercial buildings. The one respect in which the new energy bill is narrower than the conference report is the credit for existing-energy efficient homes.

G. <u>Clean Coal Incentives</u>

The new energy bill contains production and investment credits for clean coal facilities but excludes the conference report's shorter amortization period for pollution control equipment. Taxpayers must meet certain standards and obtain a certificate from the Secretary of the Treasury before they can claim the credit. Certain tax-exempt organizations, such as municipal power authorities, electric cooperatives, and the Tennessee Valley Authority, would be permitted to procure such certificates and sell, trade, or assign them, or use them to offset certain debt payments.

In general, a production credit is available for electricity generated from facilities retrofitted, repowered, or replaced with currently available clean coal technology. Investment and production credits are also available for qualified facilities that meet certain advanced capacity, thermal efficiency, and emissions standards. The amount of the advanced clean coal production credit depends upon the year the facility was placed in service, whether the facility produces solely electricity or electricity and fuels or chemicals, and the rated thermal efficiency of the facility. A facility must qualify for both the investment and production credit for advanced clean coal technologies to take either credit. The details of the clean coal credits are listed in the chart below.

TECHNOLOGY	TYPE OF CREDIT	AMOUNT OF CREDIT	PLACED IN SERVICE WINDOW	DURATION OF CREDIT
CLEAN COAL	Production	0.34 cents/kWh	Within 10 years of October 1, 2004	10 years
ADVANCED CLEAN COAL	Investment	10%	October 1, 2004 through December 31, 2016 (December 31, 2012 for certain technologies)	N/A
ADVANCED CLEAN COAL	Production	0.1-1.4 cents/kWh	October 1, 2004 through December 31, 2016 (December 31, 2012 for certain technologies)	10 years

H. Revenue Raisers

Unlike the old bill, the Energy Tax Incentives Act of 2004 includes many revenue raisers. These revenue raisers are expected to offset the cost of the tax incentives by $5 billion. The revenue raisers and their respective expected offsets include: (1) modification of ethanol tax incentives – $402 million (this was the only offset in the old energy bill), (2) provisions to discourage corporate expatriation – $2.7 billion, (3) provisions to discourage individual expatriation (including the relinquishment of a U.S. green card by a long-term permanent resident) – $328 million, (4) extension of Internal Revenue Service user fees – $138 million, (5) expansion of corporate tax shelter reportable transactions – $1.4 billion, and (6) addition of Hepatitis A to the list of taxable vaccines – $91 million.

On March 2, 2004, Senator Grassley stated that legislators are hoping to find additional revenue raisers of $5 billion. Also, he stated that the existing $5 billion “comes out of that $133 billion of offsets that we’ve got laying out there, that are soon going to be eaten up, probably three times.” Some of the current revenue raisers in the energy bill are also in several pending Senate bills, such as the pending transportation spending bill. Additional revenue raisers would reduce the cost of the energy tax incentives from approximately $14 billion to approximately $9 billion, which is within the $8 billion to $10 billion range targeted by the Bush administration.

I. The Future of the New Energy Bill

House Majority Leader Tom DeLay (R-Tex.) and other House members have remained tightlipped about reopening negotiations concerning energy policy, leaving many to wonder whether Congress’s third attempt to pass energy legislation will be the charm. Senate leaders, on the other hand, remain committed to passing energy legislation. Majority Leader Bill Frist (R-Tenn.) and Senate Minority Leader Tom Daschle (D-S.D.) have agreed that the new, streamlined Senate bill should be considered “swiftly, in a constrained fashion, and with as few amendments as possible.” On February 23, 2004, less than two weeks after it was introduced, the energy bill was read for the second time, but not much action has occurred since that time.

On March 2, 2004, Senate Republicans stated that they intend for the energy bill to be addressed before the April recess. While working diligently, Senator Domenici, the sponsor of the new energy bill, is said to be “somewhat frustrated” because many issues still need to be resolved, such as when the bill will reach the Senate floor, whether Republicans and Democrats can agree to limit the number of amendments offered to the bill, and whether the cost of the bill can be further reduced, as discussed above.

As of yet, it is uncertain whether the energy bill will pass the Senate. The 2003 energy bill fell through because the Senate did not have enough votes to defeat a filibuster. Many blamed Senator Daschle for failing to deliver enough Democratic votes, but this time he does not expect the same result. Although no whip count has been conducted, Senator Daschle is “reasonably confident” that there are “more than 60 votes should there be any effort to delay final passage.”

ENDNOTES

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INTERNATIONAL TAX: RECENT DEVELOPMENTS

by Alexander McGeoch[1]

New Income Tax Treaty with Japan.

The United States Senate on March 9, 2004 approved a new tax treaty with Japan. The new tax treaty will replace the existing income tax treaty between the United States and Japan, which is more than thirty years old. The new agreement modernizes the treaty relationship to reflect the changes in economic relations between the two countries that have taken place over the last thirty years.[2]

The most dramatic advances in the new treaty are reflected in the reciprocal reductions in source-country withholding taxes on income from cross-border investments. The new treaty provides for the complete elimination of withholding taxes on all royalty income. Given the importance of the cross-border use of intangibles between the United States and Japan, this is a key provision. The new treaty also provides for the complete elimination of withholding taxes on certain interest income, including interest income earned by financial institutions, and on dividend income paid to parent companies with a controlling interest in the paying company.

The new U.S.-Japan tax treaty will enter into force when the required exchange of instruments of ratification between the two countries is completed.

New Protocol to U.S.-Netherlands Income Tax Treaty.

The United States and the Netherlands on March 8, 2004 signed a new protocol to the 1992 income tax treaty between the countries. The Protocol modernizes the provisions preventing inappropriate exploitation of the treaty to take into account economic developments and changes in treaty practices over the past decade. The new rules are simpler, clearer and more effective. The Protocol provides for exclusive residence-country taxation of certain intercompany dividends. The Protocol provides clear rules regarding the treatment of investments made through partnerships, allowing flexibility in business form. The Protocol further coordinates the two countries’ tax rules relating to pensions, allowing individuals to take employment opportunities in either country without concerns about unintended tax effects on their retirement benefits.[3]

Extraterritorial Income Exclusion.

For years the United States and the European Union (EU) have fought an extended battle over alleged export subsidies granted by the Internal Revenue Code. In response to earlier complaints by the EU that the Foreign Sales Corporation (FSC) regime violated the rules of the World Trade Organization (WTO), Congress repealed the FSC rules and replaced them with the extraterritorial income exemption (ETI) tax benefit for exports.[4] The EU again complained to the WTO that ETI is an export subsidy that is impermissible under the WTO agreements. The WTO ruled in favor of the EU and granted the EU the right to impose retaliatory tariffs on imports from the United States. The EU began imposing the tariffs on March 1, 2004.

Both the United States Senate and the House of Representatives recognize the need to repeal the ETI. Their members, however, are engaged in a rancorous debate over the nature and scope of compensating tax benefits for U.S. manufacturers that should be included in any replacement legislation.

Results of Offshore Voluntary Compliance Initiative.

Under the Offshore Voluntary Compliance Initiative (OVCI) taxpayers who used offshore payment cards or other offshore arrangements to avoid United States income tax were able to avoid specified tax penalties. Specifically, the IRS would not impose the civil fraud penalty, the fraudulent failure to file penalty and information return civil penalties for failure to comply against taxpayers who participated in the OVCI. The IRS, however, may assert the delinquency penalty, the accuracy penalty, or both. Taxpayers are required to pay the delinquent taxes and interest under the OVCI.

Taxpayers had to opt into the OVCI by April 15, 2003. The IRS accepted 94% of the 1,300 applications it received under the OVCI program and collected more than US $170 million in tax, interest, and penalties. The IRS found that many different financial arrangements were used to avoid U.S. taxes, including foreign entities, foreign bank accounts, foreign trusts, and credit cards. The IRS reported that the transactions were very complex and involved professional individuals with high incomes and high net-worth.

The IRS announced that almost 500 promoters have been identified as a result of the OVCI, and 230 of those were previously unknown to the IRS. Of the 479 promoters named on applications, 211 were duplicates named by more than one individual, 56 were foreign individuals or companies, and 32 were previously identified outside the OVCI. Several of the promoters named by OVCI participants are already under active investigation — civil or criminal — by the IRS. The IRS plans to continue to analyze the types of schemes involved in offshore transactions.

Application of U.S. Tax Treaties to Foreign Service Partnerships

Revenue Ruling 2004-3 provides guidance regarding the application of U.S. tax treaties to nonresident partners of foreign partnerships. The facts of the ruling address the treatment of nonresident partners of a service partnership established under German law with a fixed place of business in both Germany and the United States under the 1989 Germany-United States tax treaty, as amended. The ruling interprets Article 14 of the treaty as establishing that a nonresident partner of a foreign partnership is subject to U.S. net income taxation on its allocable share of income from the partnership, provided that the income is attributable to the partnership's U.S. permanent establishment, regardless of whether the nonresident partner performed services in the United States.

The holding is considered applicable in interpreting other U.S. tax treaties with income attribution provisions similar to article 14 of the Germany-United States treaty.

The ruling turned on the determination of whether an individual partner in a service partnershipwho performs services only in his home country, but who derives income attributable to the fixed base of the service partnership in the other treaty country is taxable on that income. The ruling concludes that even though the partner does not perform any services in the other country that, the fixed base of a partnership is attributed to its partners under section 875 of the Internal Revenue Code and relevant case. Accordingly, the German service partner is treated as having a fixed base regularly available to him in the United States and is subject to U.S. net income taxation on his allocable share of income from the partnership to the extent that such income is attributable to the fixed base in the United States without regard to whether the German partner performs services in the United States.

New Form 8802: Application for United States Residency Certification.

In order to allow a taxpayer the benefit of treaty provisions, treaty partners of the United States often require the taxpayer to prove U.S. residency. On December 18, 2003 the IRS released final Form 8802, Application for United States Residency Certification, and applicable instructions. Third party intermediaries (e.g., custodian, broker, etc.) may not sign form 8802 without providing Powers of Attorney (Form 2848

Taxpayers who qualify can expect to receive certification of their U.S. residency (Form 6166) within thirty days of filing Form 8802. The IRS began accepting Form 8802 on January 5, 2004. The use of Form 8802 is mandatory as of March 17, 2004

New Form 8858: Required Information Reporting For Foreign Disregarded Entities.

Proposed Form 8858 was developed to enhance the administration of the tax law provisions applicable to U.S. persons that own Foreign Disregarded Entities (FDEs). The elective entity classification regulations facilitate the use of FDEs by U.S. persons with cross-border activities or investments. The IRS finds it hard to administer the relevant provisions of the tax law because the information reporting requirements were written prior to the creation of the FDE rules. The lack of information reporting with respect to FDEs hinders the IRS's ability to identify potential compliance issues efficiently and effectively. The IRS announced that the information to be reported on Form 8858 will help it identify issues more efficiently, thereby ensuring that the IRS can reduce the time required to complete corporate audits.

ENDNOTES

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2 United States Treasury Release, March 10, 2004, 2004 TNT 48-58.

3 Remarks of Treasury Secretary John Snow, JS-1221, March 8, 2004, 2004 TNT 46-29.

4 I.R.C. §114.

STATE TAX: RECENT TEXAS TAX RULINGS AND CASES

by David E. Colmenero[1]

The following discussion provides a summary various significant Comptroller rulings and cases decided and released within the past few months. The period covered is from December 1, 2003 to March 15, 2004. This survey focuses primarily on sales and franchise tax decisions.

Sales Tax

Hearing No. 42,163 (Jan. 23, 2004): Conveyor System and De-palletizer Held Non-Exempt Under Chevron.

Hearing 42,163 continues the saga with respect to the manufacturing exemption during the *Chevron* and *Tyler Pipe* era. The facts are set in 1997 and therefore implicate the manufacturing exemption as it existed prior to October 1, 1997. At issue is the taxability of a de-palletizer and an elaborate conveyor system used in the manufacture of canned soft drinks. The de-palletizer was used to separate cans and push them onto a conveyor for processing. The ALJ summarily ruled that the de-palletizer does not qualify for the exemption under the Comptroller's interpretation of the manufacturing exemption that mere preparatory acts do not constitute manufacturing.

The conveyor system moved the cans through a system that cleaned, filled, sealed, stamped and delivered the cans to a packer for packaging. The ALJ ruled that, to qualify for the exemption under *Sharp v. Chevron Chemical Company*, 924 S.W.2d 429 (Tex. App. – Austin 1996, writ denied), the conveyor must do more than merely provide the means for transporting materials or product from stage to stage within a unified manufacturing process. According to the ALJ, the conveyor system in this case did nothing more than move the cans from station to station and therefore did not qualify for the exemption.

While not specifically stated in the opinion, the holding of *Chevron* was largely repealed with the amendment of Section 151.318 in 1997. Section 151.318 now states that, with certain exceptions, the manufacturing exemption does not include "intraplant transportation equipment, including intraplant transportation equipment used to move a product or raw material in connection with the manufacturing process and specifically including all piping and conveyor systems…". Thus, unless one of the limited exceptions apply, the conveyor system would not qualify for the manufacturing exemption following the 1997 amendment even if it did otherwise qualify under *Chevron*.

Hearing No. 42,981 (Dec. 22, 2003): Elevator Maintenance Service Held Not Taxable

Hearing No. 42,981 addresses the taxability of certain rope replacement and rope adjustment services relative to the maintenance of elevators. The taxpayer argued that the services constitute non-taxable maintenance services. The AHS argued that the services constitute taxable non-residential real property repair and remodeling services noting language in the taxpayer's contracts to the effect that the services would be performed on an "as needed" basis.

The ALJ agreed with the taxpayer that the services constitute non-taxable maintenance services. According to the ALJ, the record established that the taxpayer had determined through experience at what usage point the ropes would need to be replaced, and at what point the ropes covered by the maintenance agreements would reach that point. The ALJ also noted that the taxpayer would schedule and budget for such rope replacements and subsequent adjustments every year.

Hearing No. 42,864 (Jan. 7, 2004): Parking Lot Refurbishment Held Taxable

Hearing No. 42,864 addresses, in part, the taxability of parking lot refurbishment work. At issue is the taxability of services to redo an asphalt parking lot with concrete. The taxpayer argued that the refurbishment work constituted nontaxable new construction and in support thereof presented an invoice showing that the asphalt was removed to the soil and replaced with concrete. Administrative Law Judge Eleanor Kim ruled that the services were taxable in this case because evidence presented by the taxpayer showed that only a portion of the parking lot was replaced with concrete. According to the ALJ, only the removal of the existing pavement in a parking lot in its entirety can be viewed as the demolition of the existing lot and the new pavement as new construction. The ALJ was also critical of the invoice presented by the taxpayer because it was obtained almost four years after the transaction occurred and appeared to be an attempt to bring the work within the parameters of a previously issued Comptroller letter ruling that addressed the taxability of a similar service.

Hearing 42,864 also addresses the taxability of services where payment is partially withheld. The taxpayer hired a company to replace the taxpayer's heating and air conditioning system. The charge was to be paid in two installments. The taxpayer made the first payment, but withheld the second payment when a dispute arose regarding the removal of the old unit. Citing to the broad definition of the term "sales price" for sales tax purposes, the ALJ ruled that both installment payments were subject to sales tax. According to the ALJ, the amount withheld by the taxpayer represented damages for breach of a contract and did not constitute a modification of the sales price.

The Comptroller's position on the withheld payment in this ruling seems improper. The facts do not elaborate much on the circumstances, but it appears that the parties simply agreed that the buyer would be excused from making the second payment and the seller excused from removing the equipment. While this agreement between the parties may not have been expressly stated anywhere, the fact that the seller did not enforce payment after almost 5 years certainly suggests such modification to the contract was intended. A modification to the sales price of this sort should be recognized for sales tax purposes. Moreover, recognizing a nonpayment as a modification appears more consistent with other provisions of the Tax Code, including Section 151.007(c)(3) which provides that a refund is excludable from the "sales price" and Section 151.426 which permits a seller to claim a bad debt deduction where the seller fails to collect the full amount on which sales tax was previously remitted.

Hearing No. 42,983 (Dec. 22, 2003): Corporate Officer Personally Liable for Corporate Sales Tax Liability

In *Hearing No. 42,981*, the Comptroller ruled that a corporate officer could be held personally liable for the sales tax liability of a corporation. The taxpayer in this case was the corporate officer of a corporation that lost its corporate privileges for failure to file a franchise tax return. The company's corporate charter was also forfeited, but was reinstated several months later. The ALJ ruled that the corporate officer could be held personally liable for the sales tax liability of the corporation for the period beginning after the date the franchise tax report was due and ending on the date the privileges were revived. The ALJ noted that the taxpayer had presented no evidence that he was not a corporate officer during the period of forfeiture, nor that the liability incurred by the corporation was incurred over the taxpayer's objections or without his knowledge.

Letter Ruling 200312270L (Dec. 9, 2003) and *Letter Ruling 200312286L* (Dec. 8, 2003): Rebate Arrangements With City Upheld Despite HB 3534

Letter Ruling 200312270L addresses the applicability of the recently enacted provisions of House Bill 3534. A statewide homebuilder in this ruling, Company A, proposed to create a wholly owned subsidiary, Company B, to purchase supplies for Company A and order the delivery of such supplies to various construction sites belonging to Company A across the state. Company B would employ 20 to 25 people, maintain an established place of business and sell the products to Company A at an amount equal to or greater than Company B's costs. Company B would also enter into an arrangement with a local taxing authority for the rebate of a portion of the local tax.

House Bill 3534 amends Section 321.002 of the Tax Code to include the following language:

> "An outlet, office, facility, or location that contracts with a retail or commercial business engaged in activities to which this chapter applies to process for that business invoices or bills of lading onto which sales tax is added is not a 'place of business of the retailer' if the comptroller determines that the outlet, office, facility, or location functions or exists to avoid the tax imposed by this chapter or to rebate a portion of the tax imposed by this chapter to the contracting business."

The ruling concludes that, because Company B will maintain an office and employees and will not function to avoid taxation, Company B will be recognized as a place of business for purposes of collection and remittance of sales tax on goods sold to its customer, Company A.

Letter Ruling 200312286L also addresses the consequences of applying House Bill 3534 to a particular transaction. The facts describe an arrangement between "Company A" and its wholly owned subsidiary, "Company B." Company A is located in City A whereas Company B is located in City B. Company B has an agency relationship with another company that is also located in City B under which Company B shares in a tax rebate from City B.

Under the terms of several agreements between Company A and Company B, tangible personal property is purchased by Company B and sold to Company A. All purchased items are delivered to and held by Company A under a warehousing agreement between Company A and Company B. Company A also makes its payments directly to third party suppliers as payment agent for Company B under a cash management agreement between the two companies. The purchase and sale transactions between Company A and Company B appear to be represented entirely by book entries.

The ruling states that, under the grandfather clause of House Bill 3534, if Company B was operating as a procurement company and entered into a rebate arrangement prior to May 27, 2003, Company B should collect city tax for City B on all sales to Company A provided that the sales are delivered to Company A from Company A's warehouse located in City A until September 1, 2005 (i.e., Company B will be recognized as a place of business until then). However, the ruling states that Company B will not be considered a place of business after August 31, 2005. The ruling concludes that, after August 31, 2005, local tax would be due based on the location to which the out-of-state suppliers ship goods (i.e., City A), or any in-state place of business from which suppliers ship products to Company A on behalf of Company B.

Letter Ruling 200401320L (Jan. 12, 2004): Monitoring and Notification Service Not Taxable

Letter Ruling 200401320L addresses the taxability of certain notification services. The taxpayer in this ruling (Retailer) is in the business of providing a service that advises customers of electrical power outages at their premises. Retailer subcontracts with a third party for the service. The ruling states that the notification services provided by Retailer is a non-taxable monitoring and notification service. The ruling also states that the services purchased by Retailer from the subcontractor also constitute a non-taxable monitoring service.

Letter Ruling 200401310L (Jan. 6, 2004): Skycap and Ticket Verification Services Not Taxable

Letter Ruling 200401310L states that skycap services (assisting passengers with luggage, assisting disabled passengers with wheelchairs, etc.) and ticket verification services to ensure that only ticketed passengers board an aircraft do not constitute taxable services.

Letter Ruling 200401400L (January 29, 2004): New Sourcing Rule Applicable to Multi-jurisdictional Service Provider

Letter Ruling 200401400L provides some general sourcing rules for the collection of local sales tax on contracts to repair underground pipelines that cross multiple taxing jurisdictions. Currently, taxable services are sourced to the service provider's place of business for city, county and/or special purpose district sales taxes and the place where the service is provided for transit sales tax purposes. The ruling states that, effective July 1, 2004, taxable service providers will collect local sales tax based on where the service is performed or otherwise provided to the customer. For pipeline repair services that cross multiple jurisdictions, the ruling states that a taxpayer will have to either collect sales tax for each jurisdiction where the service is performed or use a reasonable allocation for reporting tax on taxable services that is supported by books and records. The comptroller may recalculate the charges if the allocation appears unreasonable.

The ruling also states that an allocation based on the number of pipeline miles within certain jurisdictions is reasonable when: (1) a service provider has a contract to maintain a pipeline for a set fee and service calls routinely occur over several jurisdictions; or (2) a service provider performed work that is consistently applied over the entire pipeline such as the coating, treatment or wrapping of pipelines. However, where a pipeline contractor is called out on a per-job basis for spot repairs, taxes should be collected based upon the job location.

Franchise Tax

Hearing No. 41,240 (Dec. 30, 2003): Gain From Sale of Business Division Held Unitary and Apportionable to Texas

In *Hearing No. 41,240,* ALJ Timothy Mashburn considered the apportionability for Texas franchise tax purposes of gain from the sale of a business division. The corporate taxpayer in this case ("Taxpayer"), throughout the period at issue, manufactured electrical power transformer equipment and, through a separate division (the "Division"), also manufactured uninterruptible power systems. In 1999, Taxpayer sold the Division. It argued that gain from the sale of that Division was not apportionable for franchise tax purposes because it had no connection to Taxpayer's Texas activities and was non-unitary.

The ALJ first considered an issue of first impression in this case regarding the application of the unitary business principle. The AHS argued that all income of a business division, including gain from the sale of that division, is per se unitary with a corporate taxpayer's other Texas operations and therefore apportionable, noting that Comptroller Rule 3.576(b) creates an irrebuttable presumption that all income is unitary. Citing to various U.S. Supreme Court cases, the ALJ rejected this argument. According to the ALJ, a ruling to the effect that a taxpayer cannot challenge the apportionment of a division's income on constitutional grounds would not pass constitutional muster.

The ALJ ruled that, under the unitary business principal, what Petitioner must clearly and cogently establish is that the Division was autonomously engaged in an entirely separate business enterprise from that of Petitioner and that therefore gain from its sale bore no reasonable relationship to Petitioner's activities within this State. Putting it another way, stated the ALJ, "a clear distinction between Petitioner's corporate activities in Texas and [the Division] is what Petitioner must clearly and cogently establish."

Applying the three-part test of the unitary business principle as developed by the U.S. Supreme Court, which focuses on the existence of functional integration, management centralization and economies of scale, the ALJ ruled that the Division and gain from the sale of that Division were unitary in nature and could therefore be apportioned for franchise tax purposes. According to the ALJ, the prerequisite to a constitutionally acceptable finding of unitary business is a flow of value, not necessarily a flow of goods. The ALJ further stated, "Regardless of the different nature of the product lines and the existence of separate manufacturing facilities, sales and engineering staffs and the like, value can exist in a far less tangible way that [sic] Petitioner would have it." The ALJ ultimately ruled that gain from the sale of the Division could be legally apportioned to Texas.

This ruling presents a classic example of a taxpayer winning a war, but losing the battle. While the taxpayer prevailed on an important constitutional argument, it lost on the ultimate issue regarding the apportionability of gain from the sale of the business division in this case. The ALJ correctly agreed with the taxpayer that income from a business division can constitute non-unitary income that is not apportionable to Texas for franchise tax purposes even where the corporate taxpayer has nexus in Texas. However, the language of this ruling suggests what many practitioners can likely guess: It will likely be a rare case in which the Comptroller will agree that income from a business division is not unitary with a taxpayer's other Texas operations.

Hearing No. 39,123 (Dec. 12, 2003): Taxpayer Not Permitted to File Amended Franchise Tax Return to Recompute Depreciation

Administrative Law Judge Roy Scudday ruled in *Hearing No. 39,123* that a taxpayer was not entitled to file an amended franchise tax return for an earlier year to recompute accumulated depreciation. The taxpayer ("Taxpayer") filed a refund claim on October 15, 1999 for franchise taxes for the 1993 franchise tax report year. Taxpayer sought to recompute accumulated depreciation for terminal equipment and refinery equipment based on changes to the service lives and salvage values of the equipment.

The ALJ disposed of this case by quoting Comptroller's Rule 3.547(c)(5), which states that a corporation may not amend its franchise tax report after the due date of the report except to correct an accounting error or pursuant to the invalidation of a statutory provision, rule or agency policy. The ALJ ruled that the changes sought by Taxpayer were not accounting errors, but merely changes in estimates and, as such, were not authorized. According to Taxpayer's arguments, this issue had apparently been addressed in favor of a taxpayer in two prior district court cases. However, the ALJ did not find this argument persuasive noting that unpublished district court decisions are not precedential.

Hearing No. 42,586 (Jan. 6, 2004): Throw-back Rule Held Applicable to Manufacturer

Hearing No. 42,586 addresses the application of the "throw-back" rule to certain sales by a manufacturer and distributor of vinyl acetates. The Comptroller's auditor included in the taxpayer's Texas receipts sales of tangible personal property shipped from Texas to purchasers in Alabama and Massachusetts under the "throw-back" rule of Section 171.103(1) of the Texas Tax Code. The taxpayer argued that it was not subject to the throw-back rule because its employee's activities in those states were sufficient to create constitutional nexus with those states.[2]

The Comptroller disagreed with the taxpayer's argument and upheld the adjustment. According to the ALJ, the employee's presence in these two states was merely transitory and did not create constitutional nexus with those states. The facts established that one of the taxpayer's employees visited Alabama on personal matters during which time he checked office voice mail messages and responded to telephone calls. The same employee attended a business meeting in Massachusetts. While noting that only a minimal connection is required to establish constitutional nexus to avoid the throw-back rule, the ALJ ruled that these facts did not establish the requisite constitutional nexus. Application of the throw-back rule was therefore upheld.

Letter Ruling 200312288L (Dec. 12, 2003): Merger Credit Not Applicable to a Merger Between a Corporation and a Limited Partnership

Letter Ruling 200312288L addresses the applicability of the merger provisions of Texas Tax Code sec. 171.1531 and Comptroller Rule 3.565 to a merger between a corporation and a limited partnership. The corporation at issue was engaged in doing business in Texas and proposed to merge with a limited partnership, which was also engaged in business in Texas, with the corporation as the survivor.

The ruling notes that the survivor of a merger is entitled to a credit against the tax computed on its net taxable capital under Section 171.002(b)(1) in the amount of the franchise tax computed on net taxable capital paid by the non-survivor for the applicable credit period. Because the non-survivor in this case was a partnership, which is not subject to the franchise tax, the surviving corporation was not eligible for any merger credit.

Letter Rulings 200401314L (Jan 8, 2004) and 200402373L (Feb. 3, 2004): Expanded Section 179 Depreciation Deduction Not Recognized for Earned Surplus Purposes

In these two rulings, the Comptroller announced that the expanded Section 179 expense provisions would not be recognized for purposes of the earned surplus portion of the franchise tax. Section 179 of the Internal Revenue Code was amended in 2003 to increase the $25,000 first year depreciation amount to $100,000 for property placed in service in taxable years 2003, 2004 or 2005. It also extended the definition of Section 179 property to include off the shelf computer software placed in service beginning in 2003, 2004 or 2005. In these rulings, the Comptroller ruled that this expanded version of Section 179 would not be recognized for purposes of the earned surplus portion of the franchise tax.

According to the rulings, the earned surplus portion of the Texas franchise tax is calculated based on the Internal Revenue Code of 1986 in effect for tax year beginning January 1, 1996 and before January 1, 1997. For this reason, the expanded Section 179 depreciation provisions do not apply for purposes of the earned surplus portion of the franchise tax. However, for corporations that qualify and elect to report taxable capital using the federal income tax method, the expanded Section 179 provisions will be allowed in calculating the taxable capital component as long as the same method was used in the corporation's most recent federal income tax return.

Presumably, this same rule applies to other provisions in the Jobs and Growth Tax Relief Reconciliation Act of 2003. Of particular significance to some taxpayers will be the 50% bonus depreciation allowance. The JGTRRA increased the 30% bonus depreciation provision previously added by Congress to Section 168(k) of the Internal Revenue Code under the Job Creation and Worker Assistance Act of 2002. Under the JGTRRA, a taxpayer may now claim a first-year depreciation deduction equal to 50% of the adjusted basis of qualified property for federal income tax purposes. The Comptroller's rulings above to the effect that it will not recognize the expanded Section 179 deductions for purposes of the earned surplus portion of the franchise tax should apply equally to the 50% bonus depreciation deduction as well.[3]

Letter Ruling 200401353L (Jan. 16, 2004): Apportionment of Sales Proceeds From Sale of Digital Products

At issue in *Letter Ruling 200401353L* is the apportionment of proceeds from the sale of certain digital products. Some products are generic and some could be produced on a custom basis for specific customers. These products are licensed to customers for a one-time license fee.

The ruling states that if the seller contracts to create specific digital products for a customer, receipts from that customer are apportioned to the location where the service is performed. To the extent the digital products are not created for any specific customer, the gross receipts should be considered receipts from the use of a license and sourced to Texas to the extent the license is used in Texas.

Procedural Issues

Comptroller v. Lexington Insurance Company, 2004 Tex. App. LEXIS 1693 (Tex. App.—Austin, Feb 20, 2004, no pet. history): Protest Letter Held to Qualify as Refund Claim Where Taxpayer Failed to Initiate Lawsuit Within Required 90-day Period in Insurance Tax Case

The Third Court of Appeals in Austin, Texas recently decided the case of *Comptroller v. Lexington Insurance Company*, 2004 Tex. App. LEXIS 1693 (Tex. App.—Austin, Feb 20, 2004, no pet history), in which it determined that a protest letter qualified as an administrative refund claim, thereby providing a jurisdictional basis for filing a lawsuit in district court. While the case involves unauthorized insurance premium tax imposed on insurer policies under the Texas Insurance Code, the procedural issue decided in this case applies equally to other taxes administered by the Comptroller.

The taxpayers in this case are three "surplus lines insurance companies" that were assessed an unauthorized insurance premiums tax under the Texas Insurance Code by the Comptroller. The insurance companies ("Insurers") argued that, because they were "eligible surplus lines insurers", the unauthorized insurance premium tax did not apply to them. After receiving the deficiency assessments from the Comptroller, the Insurers challenged the assessment through the Comptroller's administrative appeals process. Thereafter, the Insurers paid the taxes under protest and simultaneously filed a motion for rehearing. The Comptroller denied the motion for rehearing several months later.

On appeal to the trial court, the Insurers sought a refund on the basis that, because they were "eligible surplus lines insurers", the unauthorized insurance premium tax did not apply to them. However, apparently due to the Comptroller's delay in denying the motions for rehearing, the Insurers did not file their lawsuit with the District Court challenging the Comptroller's decision within 90 days of filing the protest letter as required by the Tax Code.[4] The trial court nevertheless granted summary judgment in their favor. On appeal to the Third Court of Appeals, the Comptroller argued that (1) the trial court did not have jurisdiction over the refund suits because the insurers did not exhaust administrative remedies, (2) the trial court did not have jurisdiction to render declaratory judgment because such action cannot stand on its own in the absence of a refund suit, and (3) the insurers were liable for the unauthorized insurance premium tax because they failed to comply with the statutory requirements to lawfully conduct surplus lines insurance.

The Insurer's argued that the trial court had jurisdiction over their claims because the protest letters qualified as claims for refund under Sections 111.104 and 112.151 of the Tax Code, notwithstanding that they did not use the magic word "refund." They further argued that because they timely filed their petitions with the trial court within 30 days from the date the Comptroller denied their motions for rehearing, the trial court had jurisdiction over their claims.[5]

The Court initially noted that when taxes are disputed, the Tax Code provides two distinct types of suits, with different procedural requirements: protest suits and refund suits. According to the Court, the purpose behind protest suits is to provide an adequate legal remedy whereby a taxpayer may test the validity of a tax without having to resort to the traditional equitable remedy of injunction, which would restrain the state's collection of the tax and disrupt the tax-collection process. A refund suit, on the other hand, serves the purpose of empowering the Comptroller to refund the payment of taxes determined to have been paid through mistake of fact or law, thereby relieving the legislature of time-consuming claims made directly to lawmakers. According to the Court, given the purposes of these two tracks, the Insurers' claims fell more appropriately within the protest-track. However, if the Insurers had adequately exhausted the administrative remedies under the refund-track, there was nothing in the Tax Code, according to the Court, that would prevent them from maintaining this refund suit.

The Court ultimately held that the Insurers in this case had substantially complied with the refund claim requirements of Section 112.151 and the district court therefore had jurisdiction to consider the claims. The Court noted that, by the time the insurers filed their respective protest letters, they had been embroiled extensively in conflict with the Comptroller through the redetermination process, and, therefore, each side was well aware and on fair notice of the opposing side's legal arguments and position. According to the Court, the policy behind the exhaustion-of-administrative-remedies doctrine is to allow the appropriate agency to resolve the issues and to encourage the parties to resolve their dispute without resorting to litigation. There are also several exceptions to the doctrine, including, in part, where an administrative agency purports to act outside its statutory powers. In this case, noted the Court, if the Insurers prevailed on their argument that the Comptroller was acting outside her authority in assessing these taxes, the administrative requirements for a refund in the Tax Code would be mere formalities.[6]

According to the Court, the policy behind the exhaustion-of-administrative-remedies doctrice was not served in this case. On the contrary, at this stage in the proceedings, held the Court, the policy would be better served, if the Court resolved the question of law at issue in this case (i.e., the meaning of Former Article 1.14-1, section 11 of the Insurance Code). Under these particular facts, held the Court, requiring the taxpayers to file technically correct refund claims and proceed through duplicative hearings when the Comptroller was on notice of the legal bases for their claims would serve no purpose.

The Court concluded stating, "Because the Insurers rely on a strictly legal argument that they could not be taxed under the statute authorizing taxes on unauthorized insurance premiums, and in light of the protracted administrative process already completed, their payment under protest could not reasonably be regarded as anything but a request for a refund."

The Court then summarily dismissed the Comptroller's second argument challenging the trial court's jurisdiction over the Insurers' declaratory judgment claim on the basis that the declaratory judgment claim cannot stand on its own. The Court held that its prior holding that the Insurers exhausted their administrative remedies before filing their lawsuit conferred jurisdiction on the district court and therefore the Insurers' declaratory judgment action need not stand on its own.

The Court finally considered at length the provisions of former Article 1.14-1 of the Texas Insurance Code, titled "Unauthorized Insurance." The Court concluded that, under those provisions, surplus lines insurers—eligible or not—are liable for the unauthorized insurance premium tax imposed by former Article 1.14-1 if they have not placed the insurance through a licensed Texas surplus lines agent or if the insurance has not been independently procured.[7] The Court therefore held that the district court erred in declaring that eligible surplus lines insurers are not subject to former Article 1.14-1 of the Insurance Code and remanded the case to the district court for further consideration.

The Court's holding demonstrates a refreshing willingness to relax rigid administrative rules where their enforcement would only prove futile in light of their overall purpose. In this case, it would appear unreasonable and futile to require the Insurers to file a claim for refund and go through the redetermination process again as a condition to filing a lawsuit. However, one should note that the court has made clear that its holding is limited to the particular facts of this case. Thus, particularly considering the unique facts of this case, it seems highly uncertain that, in any other context, the Court would be willing to consider a protest letter as the equivalent of a refund claim or that it would be willing to excuse a taxpayer from having to file a refund claim simply to keep from having to reassert its arguments. Caution would dictate complying with the literal requirement of the Tax Code, even if it requires filing a refund claim that reasserts claims previously made.

Hearing 42,448 (Dec. 12, 2003): Taxpayer Denied Administrative Review on Dispute Relating to Voluntary Disclosure Agreement

In *Hearing 42,448*, the Comptroller denied a taxpayer the right to administrative review of disclosures made on voluntary disclosure. The taxpayer entered into a voluntary disclosure agreement with the Comptroller's Business Activity Research Team (BART) for tax collected and not remitted on taxable services in Texas. Petitioner sought a redetermination hearing after receiving a Notification of Examination Results claiming that information previously submitted to the BART upon which the assessment was based did not separate taxable from non-taxable sales. Petitioner also requested an adjustment because information disclosed to the BART was based on accrued amounts as opposed to the cash basis of accounting. Petitioner also sought waiver of interest.

ALJ Timothy Mashburn rejected the taxpayer's request for redetermination. Mashburn ruled that the taxpayer's disclosure and past liability determined pursuant to a voluntary disclosure agreement is not subject to review and redetermination through the hearing process. Execution of a VDA, according to the ALJ, is strictly governed by the agreement itself and the Comptroller's policies and procedures applicable thereto. The ALJ also noted that the standard VDA does not provide for review and redetermination of the liability resulting from disclosure through the redetermination process otherwise available. Accordingly, the taxpayer's request for redetermination was not properly subject to review.

The Comptroller's voluntary disclosure program is fairly generous. In certain cases, it provides for the waiver of both penalty and interest for taxpayers who voluntarily disclosure to the Comptroller non-compliance with the State's tax law. It can also operate to limit a taxpayer's liability for tax to four years where the statute of limitations does not otherwise apply. The procedures for doing a voluntary disclosure prescribed by the Comptroller are set forth in Tax Publication 96-576 and should be strictly followed.

The caveat ascertainable from this decision is that any dispute arising from information disclosed to the Comptroller as part of the VDA process may not be subject to administrative review, unless the VDA specifically provides for such review. As noted in the opinion, the standard VDA does not include such provision. A taxpayer who anticipates a dispute with the Comptroller arising from any disclosures made to the Comptroller as part of the VDA process will want to request a provision in the VDA entitling the taxpayer to an administrative review if the taxpayer wants the benefit of such review.

ENDNOTES

1 *Meadows, Owens, Reed, Collier, Cousins & Blau, L.L.P.; 214-744-3700; DColmenero@meadowsowens.com*

2 As noted in the opinion, Section 171.103 states that, in apportioning gross receipts, business done in this state includes sales of tangible personal property shipped from this state to a purchaser in another state in which the seller is not subject to taxation. *See* Tex. Tax. Code § 171.103(1). This is generally referred to as the "throw-back" rule because sales are "thrown back" to Texas if the taxpayer is not subject to tax in the state to which the items are shipped.

3 *See Letter Ruling 200204014L* (April 26, 2002)

4 Section 112.052 requires that the lawsuit generally be filed before the 91st day after the date the protest payment is made. See Tex. Tax. Code sec. 112.052(b).

5 Section 112.151 of the Texas Tax Code states that a person may sue the Comptroller to recover an amount of tax, penalty, or interest that has been the subject of a tax refund claim if the person has: (1) filed a tax refund claim under Section 111.104 of the Tax Code; (2) filed, as provided by Section 111.105 of the Tax Code, a motion for rehearing that that been denied by the Comptroller; and (3) paid any additional tax found due in a jeopardy or deficiency determination that applies to the tax liability period covered in the tax refund claim. See Tex. Tax Code sec. 112.151(a). Section 112.151 also requires that the suit be filed before the expiration of 30 days after the issue date of the denial of the motion for rehearing. See id. §112.151(c).

6 The Insurers argued that the Comptroller had no authority to declare them unauthorized insurers because such authority rested exclusively with the Commissioner of Insurance.

7 The provisions of Article 1.14-1 are now codified in Chapter 101 of the Insurance Code. See Tex. Ins. Code, chapter 101 (Vernon's 2004 Pamphlet).

HOW TO MAKE "SAUSAGE" OR HOW TO FUND PUBLIC EDUCATION – STATE TAX REFORM FROM A LOBBYIST'S PERSPECTIVE

by Jody Richardson[1]

As this article is being written, plans for a Special Session of the Texas Legislature have been made in the State Capitol, and news reports are replete with a variety of state tax scenarios. At this point, it is not known whether the Governor will call a Special Session to deal with school funding and tax reform. Even if a Special Session is called in April or May, and produces legislation addressing funding for public education, it is likely that tax policy questions will continue to confront elected officials during the 79th Legislature of the State of Texas, set for January of 2005, as lawyers read and re-read legislation passed this Spring.

This article is presented in sections intended to provide background and explanation of (1) why state tax policy will be addressed this Spring and/or in the next Legislative Session; (2) who the decision makers are; (3) what the background politics are; (4) what proposals are under consideration; and (5) most importantly, what their price tags are expected to be. At this early stage of the Legislative process, none of the proposals have been made in the form of draft legislation. For the most part, one must` rely on press releases, news articles, and public and private statements.

The purpose of this article is to provide some insight into the politics behind what could be the most significant changes in the system of Texas' taxation in many years. Tax lawyers generally focus on the end results of the Legislative process, i.e., the legislation that is enacted into law. This article is an attempt to provide some insight into the beginning of that process.

THE PROBLEM

The problem can appear simple: how does a State pay for public education? But one look at the layers of complexity that immediately reveal themselves to the curious observer proves that the problem is anything but simple. Does it make a difference if the State borders Mexico and faces substantial immigration and language issues? What if the State constitution has been the subject of litigation and the courts have required the State's public education to be provided in an equitable and adequate fashion? What if the State's leaders desire to improve education and produce higher numbers of graduates who perform better each year on standardized tests? Does it make a difference if the Legislature of the State is Republican-dominated and is fearful that new taxes will harm the State's determined effort to bring economic development to Texas?

Robin Hood. In Texas, financing of public education has proved to be a morass for at least the past twenty years. The State's public education funding system was litigated numerous times prior to the establishment of the current method. In 1993, the Legislature addressed the court's demand for equity in funding by mandating a policy of "taking" school tax revenues from the rich school districts and "giving" that money to the poor school districts via what now universally is known as the "Robin Hood", or recapture, system of public school financing.

When "Robin Hood" originated, very few school districts contributed to the recapture system. Chapter 41 of the Education Code sets forth a formula that results in property tax revenues being "taken" from wealthy school districts. Chapter 42 of the Education Code covers those school districts that receive those recaptured funds. As property values have risen, school districts have transitioned from being "Chapter 42 districts" to "Chapter 41 districts", and now there are at least 134 school districts whose tax revenues are being redistributed. Commonly heard monikers often are revealing. When a legislator expresses frustration over the "terrible Chapter 41 problem", the listener understands the speaker is concerned about the wealthy districts in his or her area. This hostility toward the recapture system is especially strong in suburban areas, where property wealth is fastest and strongest. Some school districts are unable to raise taxes (the reason that they cannot will be explained under the next subheading in this article), and yet they cannot provide the staffing and services their students' parents desire, and indeed, often they must cut programs to meet budget.

The frustration was so high during the 2003 Legislative Session, that Representative Kent Grusendorf, Republican Chairman of the House Public Education Committee, included language in House Bill 5 that would repeal the funding provisions of Texas' education system as of September 1, 2004, in order to force the Legislature to convene and replace it. The education establishment feared such a plan, likening it to jumping out of an airplane with a parachute that would be designed while the jumper was in the air, and ultimately persuaded Representative Grusendorf to compromise on the language. Currently the law contains the repealer, but repeal is conditioned upon passage of a system to take its place, rendering it meaningless other than as an expression of the direction the Legislature would go.

For all the complaints in the media about the need to kill Robin Hood, it is important to recognize that far more school districts are benefiting from revenue recapture than are being penalized. Those legislators who have pledged to "abolish Robin Hood" in order to get elected or re-elected, may learn that is will not be that easy to do.

M&O Cap. Also in the 1993 legislation, lawmakers capped the amount of tax a school district could levy for maintenance and operation expenses ("M&O") at $1.50 per $100 in value. Thus, the "Chapter 41 school districts" face budget cuts in their personnel and services since they are unable to increase local taxes, while they send millions to the State Comptroller for redistribution in other parts of the State. School districts face no limitation on debt service tax rates, although they must prove special circumstances to obtain approval from the Texas Attorney General to go above a 50-cent tax rate.

The State's Share. An additional contributing factor to the complexity of public school financing is the funding formula Texas has chosen. Like most states in modern times, the State funds a Foundation School Program, which provides a guaranteed minimum amount of funding per student, based upon a formula. In Texas, it "backs into" the amount the State will be required to fund, so that as local property values have risen statewide, the tax revenue that the local school districts collect has increased, and therefore the State's share has proportionately decreased. A system funded 60% by the State only a few decades ago, is now funded 68% by property taxes levied and collected by local school districts. This fiscal shell game is practiced from California to New York as the federal government, states, and local government entities attempt to meet their obligations by passing costs on to another level of government.

Tax Revolt. To illustrate the problem, consider a retired couple who own their home in West University Place, a small municipality within the City of Houston. Orville and Harriett purchased the home for $20,000 just after World War II, raised a family there, and eventually paid off the mortgage. Statistics show that property taxes have increased 124% over the last 10 years, compared to a 45% increase in personal income over the same period. Their home now is on the appraisal rolls of Harris County for $400,000, and their tax bill is now nearly $20,000 annually. Imagine the cards, letters and phone calls being sent to State lawmakers from thousands of citizens like Orville and Harriett in this situation, and it is easy to understand why legislators and statewide officeholders all are calling for property tax relief.

In fact, a local activists' organization was created in Houston, whose web site states "The tax revolt has begun!" The group is C.L.O.U.T. (Citizens Lowering Our Unfair Taxes). C.L.O.U.T. hopes at a minimum to make sure Harris County's elected officials are bombarded with pleas for property tax relief, but it seems to have gotten the attention of officials beyond those borders. C.L.O.U.T. has become close to Governor Rick Perry, and the Governor in early March proposed a four-prong program to address the group's interests (details discussed in this article below).

Future Shock. All across the nation there are cries for improved primary and secondary education. The federal "Leave No Child Behind" Act passed by President Bush is but one example of the determination to improve the education process. Dr. Steve Murdoch of Texas A&M University, the State demographer, produced statistics that raised concern here: the current Texas population is at 22.1 million, and by 2040 it will be nearly 50 million. In 2040, the population will be 78% Hispanic. Dallas Independent School District provides additional data: the State's school system grows by approximately 70,000 students annually, and during the 1990's, more than 60% of new students qualified for Limited English Proficiency and/or special education designation. Currently, 25% of the workforce in Texas has no high school diploma.

Brainpower vs. Manpower. The current education funding system appears to unfairly target capital-dependant businesses, based on a comparison of the property tax bill paid by a refinery and that paid by a call center or microchip design business. As the nation's manufacturing sector relocates to other parts of the globe, the nation's and Texas' business base becomes dominated by service providers. Many business taxpayers advocate reform of the property tax system without regard to how public education is funded, to bring equity to this perceived unfairness. The so-called "capital intensive" sector of the economy feels it pays far too much in property taxes, and that the service sector is not paying its share. This sector logically would seem an ally for the homeowners who oppose high property taxes, but it is not. Capital intensive businesses typically fear that homeowners will win this fight, and they will ultimately pay their share plus homeowners'.

Snapshot. Here is where we are today:

- Current Texas population is 22.1 million.
- 13 million live in Houston, DFW metroplex, and Austin/San Antonio.
- The Foundation School Program = almost $27 Billion.
- If federal funds, textbook costs and the cost of educator and administrator pensions, are added, the overall cost to Texas is $40.7 billion.
- Texas spends $7,152 per student/national average is $7,829.
- $1,000 more per student which costs $4.2 billion annually.
- Over 400 of the 1037 districts in Texas currently tax at the $1.50 cap on M&O taxes, and 300 more are perilously close.
- To cut the M&O tax rate by 50% requires a shift from property taxes to some other form of tax of $8 billion.

- “Robin Hood” only re-distributes $1.1 billion annually.

- Inflation and student population growth cost $1 billion annually.

- By 2040, state will be 78% Hispanic, 24% Anglo, and the rest will be Black and “other”.

- Currently 25% of the workforce has no high school diploma.

- By 2030, 1 in 5 Texans will be over 65.

- Legal experts thinks the State must pick up at least 70% of public education costs, or the courts will reinstate a “Robin Hood” recapture scheme to resolve new equity claims. Estimates are that to do so means a shift from local property taxpayers to State taxpayers in the amount of $8-12 billion.

- Each 10-cent reduction in the property tax costs $1.1 billion annually.

- Texas is a relatively low tax state: 48th in state taxes paid per person……39th in state and local taxes paid per person….46th in % of personal income in state and local taxes.

- A Texas family earning $44,000+ pays $837 in property taxes and $1,100 in sales taxes annually.

- Texas is the 8th largest economy in the world.

- 54% of school property taxes are paid by business, but the national average for business is 41%. Such a burden could negatively impact the State’s ability to attract new business.

Predictions. Given this background, an objective observer could surmise that any rational public education funding system Texas legislators adopt likely might include the following elements:

- Meet constitutional and statutory standards of equity and adequacy;

- Reduce the dependence of the system on local property taxes, possibly eliminating “recapture” funds,

- Ensure school districts have meaningful discretion over funding and education programs;

- Encourage school district accountability;

- Eliminate unnecessary complexity in the system’s arcane funding formulas, while continuing to recognize legitimate differences in costs of educating “special-needs” students and geographical differences.

- Promote educational excellence by adequately incentivizing efforts to recruit, reward and retain qualified educators based on performance; and

To address the elements listed above, and to achieve either significant property tax relief or better schools, and certainly both, necessarily will cost more than Texas spends today—which means Texans will face new taxes in 2005, and beyond.

THE PLAYERS

As April draws near, the pressures on various players are coming to a boil. The most important player is the Governor, who has the only vote that counts in considering a Special Session. He and he alone may call a Special Session, and it is his political future at stake in making the decision. In Texas, special sessions may last a maximum of thirty days, although there can be as many special sessions as a governor cares to call. All legislation dies at the end of each thirty-day period, and bills must be re-filed and heard again by their respective committees in each session.

The Governor. Governor Rick Perry, in his first full term, facing re-election in 2006, is figuratively between a rock and a hard place. Homeowners (many of whom are voters, of course) are clamoring for property tax relief, yet businesses, who typically fund political campaigns through their political action committees or “PACs” , do not want to pay more in tax than they pay today, and many would prefer to pay less.

In the months leading up to a Special Session, Governor Perry appeared to send up a series of trial balloons, testing various positions. In January, he said although there might be a Special Session, he would not support “new money” and would insist on better use of existing education funding. The education establishment and even some business groups blasted that position, and Governor Perry announced a new position, proposing $500 million in new money for incentives, but only if tied to performance. Also during this period, he continued his efforts to attract new business to Texas, acting on his conviction that one solution to the funding problems is to “grow the economy”.

Meanwhile, the Governor’s Chief of Staff began discussing a proposal known as the split roll system, whereby residential property would be taxed at a lower rate than non-residential property. The plan called for a constitutionally guaranteed cap to the tax rate, and a process whereby the tax rate would be “bought down” to around 75-cents per $100 valuation. The chief of staff called the plan a temporary split roll. The Governor was careful to not embrace this plan as his own, as over time, the opposition grew ever stronger.

On March 11, the Governor sent the clearest signal to date that he is going to call a Special Session. He called a press conference to outline his plan for ensuring property tax relief is “real”. Mr. Perry proposed a 3% per year cap on the amount a residential appraisal could increase (current law limits it to 10%), and noted it would be imperative for any tax relief plan to include protection against property value “creep”. In addition, he proposed a limit to the amount of property tax revenues all local governments can collect, tied to inflation and population growth factors, unless increases above the caps are approved by voters. Revenues would be allowed to increase based upon new home and apartment sales, for schools average daily attendance (“ADA”) growth, and an inflation factor. He also called for mandatory disclosure of real estate sales prices, and elected appraisal boards.

Many observers feel certain the Governor will call a Special Session, partially because so much groundwork has been done. Most of the capitol crowd thinks this is a bad idea, not only because business doesn’t want to pay more taxes, but because of the partisan rancor and the virtual certainty that the Democratic challenge will occupy hours of biting criticism on the microphones in the House and Senate. The Democratic Party issued statements that appeared to goad

Perry into calling a Special session by implying he would be lacking leadership if he failed to do so. Fifty-four year old Rick Perry, a former Commissioner of Agriculture and former legislator, is an ambitious public servant. He probably wants to serve two full terms as governor, in addition to the two-year term he completed for George W. Bush after Bush was elected President of the United States. Such a ten-year tenure would be record-setting and represent quite a legacy for the former Democrat from rural Haskell, Texas.

Moreover, with two and one half more years in his first term still ahead, amid the public outcry for tax relief, a refusal to call a Special Session might present far too dangerous a source of ammunition for political foes, including both current Comptroller of Public Accounts Carole Strayhorn, and current United States Senator Kay Bailey Hutchison, both believed to be eyeing the Governor's Mansion. Though Governor Perry may have little hope for success, he can blame any failure on the members of the Legislature, once he sets the wheels in motion, and the Special Session begins.

Lt. Governor. As of the date of this writing, Lt. Governor David Dewhurst has stated he prefers to begin the debate in the Special Session with a bill that looks like the bill "his Senators" passed in the Regular Session of 2003, although reports reveal he is looking seriously at a BAT or business activity tax. The 2003 legislation promised a 50% decrease in local school taxes by broadening the sales tax base to include currently exempt items, such as many personal services and motor vehicle repair, home remodeling, lawyer and CPA professional services, as well as a one-cent sales tax rate increase. As of now the Lt. Governor opposes gambling.

Mr. Dewhurst faces the Special Session with new chairmen of Education and Finance, due to the resignations of Senators Bivins and Ratliff, and a new parliamentarian. This is a disadvantage, but not a fatal one. In fact, the lack of experience on the Senate floor may put him on a more equal footing with his Senators.

Mr. Dewhurst's ambition probably is to serve as Lt. Gov for two terms, and as Governor for two terms (each term consists of four years), making this life plan a 16-year journey.

Comptroller. Carole Keeton Strayhorn, "One Tough Grandma", has stated she favors authorizing and taxing slot machine-like video lottery terminals ("VLTs") at racetracks, and increasing the sales tax on tobacco products, but has not declared a preference for any new business tax. She has questioned the wisdom of a split roll tax and a gross receipts tax. She denies advocating an $80,000 homestead exemption, and asserts that the Governor is spreading this rumor. She has expressed concern about a one penny increase in the state sales tax rate, noting that Texas then would have the highest sales tax rate in the nation.

The Comptroller traditionally produces the drafting for any tax bill, and provides the expert opinion as to efficacy of any tax scheme in practice. It is the Comptroller who must enforce and interpret tax law. Mrs. Strayhorn has been noticeably quiet during the committee hearings and press briefings, but she has promised to release her own plan for public school funding once a Special Session is under way.

As a former school board member, she has credibility when she complains that only 51% of school taxes reach the classroom. She additionally has in her resume numerous audits of school districts, and announcements of cost savings identified and ordered, notwithstanding the fact that the Legislature removed some of her audit powers after her acrid criticisms in 2003 of Legislative spending. At age 67 it may be now-or-never for her to run for Governor.

The Court. Numerous school districts have sued the State, claiming that the current public education system is unconstitutionally inequitable and inadequate. The trial date has been set for July 26. A four- week trial is projected. Any Special Session must achieve a new plan prior to this date in order to avoid the trial.

Joint Select Committee on Public School Finance. Created by the Speaker and the Lt. Governor, this interim committee is composed of 16 members, equally divided between House members and Senators, plus four public members. The committee charge is to focus on school improvement, the adequacy definition and funding options. The committee received a report on the cost of an "adequate" education on March 4. The controversial finding by the committee's expert was that Texas already pays more than the cost necessary for an adequate education. "Adequate" was defined as a system that produces a 55% TAKS passing rate, which many committee members opined was "inadequate". The group's final report is due March 16, and a preview copy of the Executive Summary was made public on the evening of March 8.

The committee members appear dedicated to finding a good solution, although it is not clear that it will raise enough money to provide property tax relief, invest new money in the system, call for greater student and teacher performance, and yet not harm economic development efforts in the State.

House Select Committee on Public School Finance. This committee is composed of 29 members of the House of Representatives, appointed by the Speaker of the House, Tom Craddick. The committee is divided into 9 subcommittees, and recommendations of each subcommittee, save the tax subcommittee, were released in the first week of March. Many of the subcommittee recommendations were incorporated into the leaked executive summary of the Joint Committee's report, such as flexibility in class size, and easing the complexity of terminating poor performing teachers.

In February, Chairman Kent Grusendorf pledged that the committee recommendations will be ready by April 1, in time for a Special Session. Grusendorf has made no secret of his preferences: reduction of M&O taxes to at least 75 cents, elimination of Robin Hood, and some substantive reforms. To achieve his goal, he favors a modified BAT and some of the consumer services currently exempt from sales tax becoming taxable.

Business Groups. Business groups are, by definition, well organized, and many have professional tax advisors on hand. Some groups have published proposals on new state taxes and school funding. As this article was being written, rumors were swirling that as many as 30 business groups would formally release a joint statement opposing the Governor's appraisal cap proposal, and urging consideration of non-tax sources of new revenue plus even more cost cutting than was accomplished in the 2003 Session.

Texas Taxpayers and Research Association ("TTARA"). This group is a merger of the old Texas Taxpayers Association and the Texas Research Association, and includes dozens of members representing a wide array of businesses including oil and gas companies, telecommunications companies, banks, law firms, timber companies, chemical companies, retailers and food manufacturers. Officially, the group does not have a position, but unofficially, it prefers small changes to existing taxes, as contrasted with a major tax overhaul. It advocates a broad base of tax revenue sources, in contrast with one big business tax or a personal income tax. "The devil you know is better than the devil you don't know", appears to be one of its guiding principles. It must officially oppose a tobacco tax, as tobacco companies are among its membership.

Texas Association of Business ("TAB"). TAB includes in its membership many of the same companies who are members of TTARA. TAB argues most forcefully of all the business groups against "throwing more money" at education. TAB proposes that public schools be required first to use their existing funds more efficiently. This group believes new state taxes will drive new business into the waiting arms of New York's Governor Pataki, for example.

Dallas Business Groups. This coalition, including the Greater Dallas Chamber and the Dallas Citizens' Council is being led by well-known Republican lawyers Mike Boone and David Laney. They advocate: (1) eliminate recapture; (2) reduce M&O tax rate to 60 cents; (3) shift 70-80% burden of public school finance from local school districts to the state; (4) add $1000 per student; (5) eliminate franchise tax; (6) impose a business activity tax to catch service sector (7) increase sales taxes if necessary; and (8) approve and tax VLTs. The price tag for this plan is the highest of the business group plans, at $12-$16 billion, $4.2 billion of which is new money, while the balance is shifted to the State from local property taxpayers.

Greater Houston Partnership. Under the leadership of Republican Rob Mosbacher, this group adopted both a short term and a long term plan. Features include: (1) elimination of residential recapture; (2) reduce local school property tax rates to $1.25/$100 value; (3) maintain the existing property tax exemptions; (4) create a "hold harmless" provision so school districts will not receive less than they do currently; (5) increase funds for bilingual education, transportation, and pre-kindergarten for at-risk children; (6) fund the Governor's excellence fund; (7) assist poor districts with facilities deficiencies; and (8) restore funding for the "9th Grade" initiative.

The group's proposal included the following template as the framework for funding the $4.6 billion needed: (1) increase the state sales and use tax rate by 1 %; (2) increase the motor vehicle sales and use tax rate by 1.0 percent; (3) increase the cigarette tax by $1.00 per package; (4) allow video lottery terminals (VLT) at race tracks; (5) increase occupation and business filing fees; and (6) improve fairness of franchise tax by closing the "Delaware sub" loophole.

The group's Long-Term Solution was that state leadership appoint a task force to evaluate the long-term restructuring of our tax system by the 2007 legislative session and sunset the "short-term" solution in 2007. That restructuring should include substantial reductions in property taxes paid by both businesses and homeowners; elimination of the current franchise tax; and addition of a mixture of tax bases with broad coverage at the lowest rates possible, including consumption taxes and a broad-based, modest rate, business tax on net income.

Consumer Groups. This category includes the Equity Center, which advocated the original "Edgewood" lawsuits on equity of funding, and the Center for Public Policy Priorities. These groups are close to the recipient (or Chapter 42) school districts, and recognize elimination of Robin Hood may not be the best strategy, especially if no new money is invested in the public education system. The CPPP advocates a personal income tax, long considered the third rail in Texas politics. This group is headed by Scott McCown, a former district judge who handled some of the equity cases, who is handling public relations judiciously.

C.L.O.U.T. or Citizens Lowering Our Unfair Taxes, emerged as a surprisingly effective group during the 2003 Regular Session, and afterward saw some of its objectives embraced by the Governor as part of his proposal.

Education Establishment. This group consists of superintendents, local school board members, and teacher groups. These representatives are sophisticated, and of all the observers, probably understand the education funding formulas and jargon best. They demand an update for the CEI index (cost of education) which has remained static for over a decade, while cost of living indexes have increased. Even if no formulas changed, if the cost of education index were to increase, schools would receive more money.

Educators are greatly concerned that legislators will not recognize that special funding for special needs must be continued. Data is clear that it costs more to educate some students in some locales. Many of these professionals are not enthusiastic about the incentives the Governor proposes. Reflecting their recognition of special needs, some fear that higher performance standards may produce more "failures" that would penalize schools simply for including a greater number of special needs students.

THE POLITICS

After decades of determined work and slow progress, Republicans now are in power in Texas government, with 88 members to 62 Democrats in the 150-member House of Representatives, and with 19 Senators versus 12 Democratic Senators in that 31-member body.

Notwithstanding a substantive agenda of reforms, Republicans are ever vigilant for procedural opportunities that might impact their majority. It is likely for that reason, that the report and recommendation from the Joint Select Committee was not ordered due until March 15, after the March 9 primary date. Logically, Republicans could not risk the hint of new taxes while the re-election of the Republican incumbents was underway.

For Republicans, consideration of new taxes goes against their mind-set, yet in order to provide homeowners with property tax relief, few other options are feasible. Republican office holders are torn—agitated constituents who want lower taxes yet better schools vs. the business lobby who funds the campaigns and who don't want to pay more than they now pay. Indeed, as recently as February, at least 37 House Republicans signed a "no new taxes" pledge, to the delight of groups like TAB, and a handful of deep-pocket business leaders.

One indicator of the choice that will be made is the legislation passed by Republicans, as well as Democrats, in the 2003 Session, allowing voters to approve authorization for local governments to freeze seniors' property taxes. Not surprisingly, though probably not beneficially for the State, the proposition was approved overwhelmingly by the voters. Predictably, more than a few municipalities are less than enthusiastic about this option that resembles a much-despised unfunded mandate. The struggle for the Republicans will be fascinating to monitor—do they maintain their no tax pledge or side with homeowners (voters)?

Consider also the dilemma the elected officials face in voting on gambling. It looks like easy money, but in the conservative wing of the Republican Party, such a policy is unacceptable. For different reasons, a tax on tobacco is a similar dilemma: how many politicians who accept contributions from the tobacco companies will vote to tax them?

The most important conundrum facing the party in power, however, is how to achieve substantive education reform. Conservative Republicans are determined not to gratuitously throw money at the problem. One of the statistics they are fond of: Texas kids attend school 175 days per year. Kids in Japan attend school 220 to 243 days.

Finally, at least two of the proposals under serious consideration require constitutional amendments. That means super majorities in House and Senate—100 votes in the House and 21 in the Senate. Obviously, the Republicans cannot pass these items alone. Will the Democrats help, or will they stand by and watch Republican efforts fail? Perhaps mirroring the national political scene, capitol regulars report a tremendous amount of partisan rancor, and one way it could be manifested is to make the Special Session a dismal failure by opposing any constitutional amendments and killing as many tax bills as possible. Imagine the election slogans in November: "Vote Democrat –Democrats Opposed all new Taxes… Republicans Raised Your Taxes", etc.

THE PRICE. Obviously, the price for public education funding depends upon who decides what needs to be funded. Roughly $ 8 billion is needed to reduce school M&O taxes to 75¢ per $100 valuation. To add $1000 per student, requires an additional $4.2 billion.

There are at least 9 tax proposals on the table:

- Versions of sales tax proposals
- Franchise tax changes
- Payroll tax
- Split roll property tax
- Personal income tax
- Gross receipts tax
- Business activity tax
- "Taxes" on "sins"
- License fees

Sales Tax. The sales tax currently raises $14.7 billion / year. Texas' sales tax ranks as the seventh highest in the nation. To some, broadening the sales tax base to include more services is attractive, and to others, raising the rate by one penny is appealing. Both ideas have significant opposition, primarily because the sales tax is regressive, and is unstable. If the economy trips, consumer purchasing will decline and so will revenues.

Existing sales tax exemptions have sound policy reasons for their support, although some appear more political than logical. In any case, lobbyists will fight vigorously to keep them. One of their best arguments is that Texas service providers would find themselves at a significant disadvantage to their peers located in other states. For example, if engineering design services become subject to the sales tax, consumers of such services can hire Louisiana or Oklahoma engineers. One proposal under discussion would subject to taxation only "consumer services", meaning those that cannot be purchased in another state such as haircuts, and car repair. Known around the Capitol as "easy marks", this proposal would raise only $500 million.

Franchise Tax. As applied, the earned surplus component of the Texas franchise tax is essentially a corporate income tax. It is in the discussion not because it is a major revenue producer, since it is not, but because of its inapplicability to partnerships. Corporations across the State have restructured themselves into partnerships in order to avoid the franchise tax, and this tax planning practice has become known as the "Delaware Sub loophole". Closely related to the problem is the Geoffrey's technique, whereby business entities can buy trademarks and other intangibles from a parent corporation in order to reduce surplus income and pay less tax. Closing the "loophole", according to Comptroller estimates, raises only $238 million annually although many tax practitioners believe that estimate is but a fraction of its true earning ability. Interestingly, if the rate on the earned surplus is increased one percent, $385 million more than closing the franchise tax "loophole" would be raised.

As was proven during the 2003 Session, closing the "loophole" is very difficult to do without causing lots of other problems. Some partnerships that should not be included in a corporation tax would have been inadvertently caught in the tax, possibly resulting in an unconstitutional personal income tax, for example.

Payroll Tax. Nevada recently adopted such a tax. The best thing about it is that it is broad based, but its other features can be classified as negative. Such a tax is not based on ability to pay, since it is based upon based on expense not revenue. This tax would hurt labor- intensive companies and it would have to be said to discourage job creation.

Split Roll Property tax. Under the currently proposed split roll scheme, residential property would be taxed at a lower rate than non-residential. Businesses in the State have vehemently opposed the concept, because they do not want to be de-linked from homeowners. Businesses envision the entire tax burden shifting to them to relieve homeowners.

In the version advocated by the Governor's chief of staff, the business tax would be collected by the state and the residential tax collected by school districts. A constitutionally capped tax rate of $1.40 for non-residential property and $1.25 for homeowners are proposed. About 15 cents in local enrichment would be permitted. To assuage business, elected appraisal boards are proposed. Most inventively, this plan envisions increasing tax revenues at the state level which over time would "buy down" the tax rates to around 75-cents per $100 valuation.

No business has embraced this plan; even homeowners' groups think it proposes too small a reduction in property taxes. The Governor announced his support for the concept in late March, much to the horror of the business groups.

Personal Income Tax. This proposal is a true nonstarter. Indeed, the Texas Constitution prohibits a personal income tax absent approval by the voters. Interestingly, recent polls show regular taxpayers appear to be more accepting of the concept than politicians recognize. Senator Eliot Shapleigh of El Paso may be the only, or at least the most aggressive, elected official who supports the tax. He advocates a 5% personal income tax tied to a 2/3 reduction in property taxes.

While an income tax is based on ability to pay, and it grows with the economy, that is one reason conservatives in both parties oppose it. People who think government will spend all the revenue it can collect are not willing to give government such a playground.

Gross Receipts Tax. This type tax can be fairly described as an income tax with no deductions. It is levied on total revenues of a business. This tax in application would hurt companies with high sales volumes but low profit margins such as grocers and retailers. A business would be required to pay taxes even if it was not profitable. The tax levied at 1% raises $9 billion/year, which absorbs the cost of a shift from local property taxes and would allow reduction of the current $1.50 M&O tax to about 60-cents.

Business Activity Tax. The proposal talked about in Texas most often establishes a tax levied on revenue, minus the cost of goods and services. Payroll would be included and taxed.

One proposal seriously being considered is Bush's 1997 proposal. The "Bush BAT" uses apportionment for multi state companies and included an exemption for the first $500,000 earned. He proposed a tax of 1.25% of gross receipts.

"Taxes" on "Sins". Note that not everyone would agree the activities and goods to be taxed are sins. Indeed, not everyone agrees such taxes are taxes, but rather are more akin to "user fees". All of the items listed below with their projected revenue stream are under discussion and look attractive to nearly everyone, except those who lobby for companies who produce the goods. One reason they are so attractive is that use of the goods to be taxed is voluntary, and to the extent they are vices, if the tax dissuades use, that is positive.

- Tobacco products= $750 million
- VLTs =$ 1 billion
- Alcohol—-500% increase = $400 million
- Gambling—who knows

License Fees. There is a proposal under consideration to increase existing professional fees, and to expand application to some professions not currently licensed. It is estimated that doubling the license fees for professionals would raise approximately $2.2 million per year.

CONCLUSION

This article has provided a view of likely state tax reform in the early stages of the Legislative process in order to, in part, explain what may seem to be illogical, irrational, or inconsistent laws that have been, or will be, passed by the Legislature by the time this article is published, to address public education funding. The cliché is apt: one should never watch sausage, or law, getting made.

Humor aside, the difficulty of balancing tax reform and public education reform cannot be overemphasized. A successful society demands the best possible education system for its young, and at the same time, careful monitoring of the expenditure of its public funds. Texas enjoys as robust an economy as any state in the nation during this period of slow recovery. Fiscal conservatives must attempt to be cautious and protective of the attractive tax environment the State employs currently. And yet the homeowner-voter cries of impossibly high taxation are increasing. Elected officials must listen to all sides of this most important and complex argument and strive to navigate a route among them that satisfies the critics and responds to society's demands. It is hoped that this article provides one perspective of that process.

ENDNOTES

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APPLYING THE NEW TAX SHELTER OPINION STANDARDS TO THE FORGOTTEN TAX SHELTER–TAX-EXEMPT BONDS

by Faust N. Bowerman[1]

The Internal Revenue Service has recently proposed new regulations governing the standards of tax shelter opinions rendered by tax professionals.[2] These proposed regulations confirm the federal government's stated initiative to combat abusive tax shelters. While practitioners are undoubtedly aware of the future applicability of the new standards to tax shelters that are considered schemes to avoid and evade federal income tax, they may not be aware that the new standards will apply to tax opinions regarding the excludability of interest payable on State and local obligations ("tax-exempt bonds") from gross income for federal income tax purposes under Section 103 of the Internal Revenue Code of 1986 (the "Code"). Given the prevailing opinion practice for bond counsel, the new tax shelter opinion standards may necessitate changes in tax-exempt bond opinions.[3] While the broad applicability of the tax shelter opinion standards serves the interest of the federal government by promoting public confidence in the honesty and integrity of the tax professionals who play an increasingly important role in the voluntary compliance based federal tax system, the Department of the Treasury ("Treasury") should recognize the need to provide specific regulatory guidance with respect to the applicability of such standards to tax-exempt bond transactions.

This article, after providing information relating to the development of both the tax shelter opinion standards and the classification of tax-exempt bonds as tax shelters, discusses the practical considerations to be confronted by bond counsel in applying the proposed tax shelter opinion standards to the opinions it renders regarding the federal tax treatment of interest on tax-exempt bonds.

Pursuant to its authority to regulate the practice of taxpayer representatives before the Treasury, the Secretary of the Treasury has issued Treasury Department Circular No. 230 ("Circular 230").[4] In 1984, Treasury amended Circular 230 to first provide standards for tax shelter opinions (the "1984 Circular 230 Amendments").[5] Tax-exempt bond opinions were specifically exempted from such standards, as the term "tax shelter" did not include "municipal bonds."[6] Seventeen years later, in 2001, Treasury proposed general amendments to Circular 230 (the "Proposed 2001 Circular 230 Amendments") and, in particular, amendments to Circular 230's tax shelter opinion standards.[7] The Proposed 2001 Circular 230 Amendments continued to exclude municipal bonds from the tax shelter opinion standards; however, the exclusion came in a different form than the exclusion in the 1984 Circular 230 Amendments. While the 1984 Circular 230 Amendments provided the exemption for tax-exempt bonds by specifically exempting such bonds from the definition of the term "tax shelter," the Proposed 2001 Circular 230 Amendments generally excluded tax-exempt bonds from the proposed rules in its explanation of the proposed provisions.[8] Structurally, the Proposed 2001 Circular 230 Amendments contained two sections that applied to tax shelter opinions, namely rules in Section 10.35 governing "more likely than not" tax shelter opinions and rules in Section 10.33 governing opinions used to "market" tax shelters. The rules in the former section did, like the 1984 Circular 230 Amendments, provide a specific exclusion for tax-exempt bonds in its definition provisions, while the latter section did not provide such an exclusion. Ultimately, Treasury withdrew the Proposed 2001 Circular 230 Amendments in connection with proposing the current amendments to Circular 230 relating to tax shelter opinion standards.[9] These new amendments when considered together remove the exemption for tax-exempt bonds in the process of combining the once differing rules applicable to "more likely than not" and "market" opinions. Treasury has stated the exemption was removed "because it would apply too broadly to all types of tax-exempt bond opinions."[10] Furthermore, the Assistant Secretary for Tax Policy at Treasury has stated the exemption for tax-exempt bonds is not "appropriate," "[b]ased on some of the things that [Treasury] was aware of," presumably opinion malfeasance.[11]

Since 1989, tax-exempt bonds, as tax shelters, have fit specifically into the federal tax statutes under Section 6700 of the Code ("Section 6700"). In 1989, congressional consideration of and change to the penalty regime applicable to the promoters of abusive tax shelters clarified the notion that tax-exempt bonds are in fact "tax shelters" for purposes of the Code. When Congress clarified the law in the Omnibus Budget Reconciliation Act of 1989 (the "1989 Act"), Section 6700 imposed, as it imposes today, a monetary penalty on any person who organizes, assists in the organization of, or participates in the sale of any interest in a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if such a person makes or furnishes a false or fraudulent statement or a gross valuation overstatement in connection with such organization or participation.[12]

Prior to the 1989 Act, the penalty in Section 6700 specifically equaled the greater of $1,000 or 20 percent of the gross income derived or to be derived by the person from the activity. Subsequent to the 1989 Act, the amount of the penalty specifically equals $1,000 or, if the person establishes that 100 percent of the gross income derived or to be derived by the person from the activity is less than $1,000, 100 percent of such gross income.[13] Congress has advised the Internal Revenue Service (the "IRS") that, in determining the amount of the penalty, it should consider the organizing of an entity, plan, or arrangement and the sale of each interest therein as separate activities.[14]

Specifically, tax-exempt bonds fit into the structure of Section 6700, as tax shelters, both as an "investment plan or arrangement" and as an "other plan or arrangement." Therefore, the monetary penalties imposed by Section 6700 of the Code

> may apply to bond counsel, investment bankers and their counsel, issuers (and beneficiaries of 'conduit' bonds) financial advisors, feasibility consultants and engineers, and other persons who (1) are involved in the organization or sale of [tax-exempt] bonds and (2) know or have reason to know that their opinions, offering documents, reports, or other statements (or material on which they relied in making such statements) are false or fraudulent as to any matter material to the tax exemption of the interest on the bonds.[15]

At the time of the 1989 Act, the notion of tax-exempt bonds being included within the broad scope of tax shelters was a point of contention with the tax-exempt bond industry, as the industry had taken the position that interest exemption was a consequence of the federal subsidy, and as such, was specifically provided by the Code. In extending the Section 6700 penalty to tax-exempt bond transaction participants, Congress, in its legislative history, confirmed bond counsel's ability to rely on information and representations provided by other parties as to matters of fact and expectation relevant to bond counsel's opinion; however, Congress emphasized that bond counsel could not rely on such information and representations if bond counsel had actual knowledge or a reason to know of its inaccuracy.[16] This emphasis is consistent with prevailing legal opinion standards, as such standards provide that opinion preparers may not rely on unreasonable or false information.[17] Moreover, in extending the Section 6700 penalty to tax-exempt bond transaction participants, Congress recognized that bond counsel must draw its own conclusions as to matters of law from the information and representations.[18] This Congressional focus on the process of a practitioner's identification of and reliance on relevant factual information and representations and application of law thereto with a standard defining what may and may not be relied upon by bond counsel in rendering its opinion is in accord with Treasury's focus in the new tax shelter opinion standards for Circular 230; however, Congress made no statements that would necessitate a fundamental change to opinion practice in tax-exempt bond transactions.

In general, the new proposed tax shelter opinion standards for Circular 230 will require opinions to:

- Identify and consider all relevant facts, and not rely on unreasonable factual assumptions or representations;[19]
- Describe the applicable law and relate it to the relevant facts, without relying on unreasonable legal assumptions, representations, or conclusions;[20]
- Provide a legal conclusion, supported by facts and law, for each material federal tax issue, including a conclusion as to the likelihood that the taxpayer will prevail on the merits with respect to such issue;[21] and
- Provide an overall conclusion on the federal tax treatment of the tax shelter item or items, with the basis for the conclusion.[22]

With respect to items of disclosure, the new proposed tax shelter opinion standards for Circular 230 will require opinions to (1) disclose, among other matters, that the opinions may not protect the taxpayers from certain accuracy related penalties[23] and (2) recommend that taxpayers obtain advice from their own tax advisors.[24] Furthermore, with respect to reliance on opinions of others, the proposed standards seem to allow practitioners to rely on the opinion of another practitioner only if the relying practitioner is not sufficiently knowledgeable in all of the aspects of federal tax law relevant to such practitioner's opinion.[25] Of course, the relying practitioner cannot rely on an opinion, if he or she knows such opinion should not be relied on. Finally, the relying practitioner must identify the other opinion and set forth its conclusions in his or her own opinion.[26]

Bond counsel will be confronted with some inherent difficulty in applying these standards to its traditional "unqualified" form of opinion regarding the validity and tax-exemption of bonds. In fact, without either guidance or revision by Treasury, the new standards could ultimately impact the marketplace acceptance, length, and cost of tax-exempt bond opinions.

First, with respect to the identification of all relevant facts, tax-exempt bond opinions have traditionally omitted a detailed description of the transaction related to the bond issue.[27] While such opinions traditionally include a specific statement that the opinion depends on the accuracy of certifications of fact made on the date of issuance, those certifications always are included in either other bond documents or in separate tax documents. In those other or separate documents, most bond counsel only include the precise facts, estimates and information relating to a given bond issue needed to render an opinion, rather than also including conclusions of law.[28] Moreover, most bond counsel refrain from using factual representations that are tantamount to their legal conclusions.[29] Customarily, the ultimate conclusions of law relating to a given tax-exempt bond transaction are reserved for the opinion. Unless specific guidance is given by Treasury, bond counsel may need to consider a fundamental change to the form of its tax-exempt bond opinions–namely, the inclusion of a complete factual enumeration. Such an enumeration will significantly increase the length of the opinions rendered by bond counsel.

Second, with respect to the description of applicable law required by the new tax shelter opinion standards for Circular 230, tax-exempt bond opinions have traditionally refrained from specifically listing the legal authorities examined by bond counsel in detail. Rather, bond counsel typically prefers to state that it has examined such law as it deems necessary to render the opinion. In this regard, a tax-exempt bond opinion generally refers to a review of constitutions, statutes, regulations, rulings, court decisions, or other authoritative sources. As bond counsel usually renders "unqualified" opinions with respect to validity and tax-exemption of bonds,[30] any form of opinion other than an "unqualified" opinion is a departure from customary practice, which in and of itself is starting point for understanding the different forms of legal opinions. Customary practice "allows the communication of ideas . . . without lengthy descriptions of the diligence process, detailed definitions of the terms used and laborious recitals of standard, often unstated assumptions and exceptions."[31] In the context of tax-exempt bond opinions, customary practice indicates that, with respect to referencing the Code, bond counsel prefers to reference the "law" generally by referring to Section 103 of the Code rather than the specific sections of the Code for different types of the tax-exempt bonds, such as, for example, Section 142 of the Code for exempt facility bonds generally, Section 142(a) of the Code for airports specifically, Section 142(b) of the Code for docks and wharves specifically, etc., and Section 145 of the Code for qualified 501(c)(3) bonds.

In light of the foregoing, if an opinion is "explained" it may be viewed by bond investors as something other than an unqualified opinion. An opinion is said to be "qualified" to the extent it contains an "exception" narrowing the opinion that is not customary in opinions of that type.[32] Anyone relying on such an opinion is thereby put on notice as to uncertainties and limitations. Accordingly, if a bond opinion contains a complete legal analysis for the opinion by "relating" the applicable law to the facts as required by the new tax shelter opinion standards for Circular 230, it may be considered by the marketplace as a "reasoned" or an "explained" opinion. Practitioners and marketplace participants claim that such a consideration would be disruptive to the market and costly to governmental issuers, as only reasoned or explained opinions contain a complete analysis of legal authorities and precedents. No doubt, reasoned opinions currently reflect a low level of certainty in the conclusions expressed therein than unqualified opinions.

If the new standards are finalized without any substantial changes, it is debatable whether a factual enumeration and legal discussion is even required in the context of an "unqualified" opinion. The argument is based on ambiguity in the new proposed rules and framed by the definition of "material Federal tax issue," which, under the new proposed rules, is "any Federal tax issue for which the Internal Revenue Service has a reasonable basis for a successful challenge and the resolution of which could have a significant impact . . . on the Federal tax treatment of a taxpayer's tax shelter item."[33] It follows that, if an opinion concludes there are no "material Federal tax issues," then the opinion is not required to set forth the facts, law, and requisite conclusions.

Finally, the new disclosure requirements create an anomaly with respect to what Treasury considers a tax shelter for regulatory purposes under one of the accuracy related penalties in the Code, namely the penalty under Section 6662(d) of the Code (the "Section 6662(d) Penalty"), and the new tax-shelter opinion standards. As previously stated, the new proposed tax shelter opinion standards require opinions to disclose, among other matters, that the opinion may not protect the taxpayer from the Section 6662(d) Penalty. The disclosure does make sense for opinions expressly issued to avoid a penalty, such as reliance opinions, but may not for tax-exempt bond opinions. In its present form with the "significant purpose" standard, Section 6662(d) of the Code dates back to 1997.[34] Prior to 1997, Section 6662(d) contained a "principal purpose" standard (the "Pre-1997 Standard"). The regulations under the Pre-1997 Standard provide that tax shelters are typically "transactions structured with little or no motive for the realization of economic gain and . . . financing techniques that do not conform to standard commercial business practices."[35] Moreover, "the purchasing or holding of an obligation bearing interest that is excluded from gross income under section 103 [of the Code]" is an example of what would not be a "plan or arrangement" with "its principal the avoidance or evasion of Federal income tax solely as a result of the . . . use[] of tax benefits provided by the Internal Revenue Code."[36] Simply stated, in the regulations applicable to the Pre-1997 Standard, Treasury appeared to take the position that tax-exempt bonds are provided by or "consistent" with the Code and Congressional purpose. As such, tax-exempt bonds were not thought of as tax shelters. Therefore, the new disclosure requirement in the new tax shelter opinion standards for Circular 230 arguably may require the disclosure of a penalty that may actually be inapplicable to tax-exempt bondholders.

Similarly, the regulations relating the registration of tax shelters under Section 6111 of the Code ("Section 6111"), which itself uses a "significant purpose" standard for identifying transactions structured for avoidance or evasion of federal income tax as does the current Section 6662(d) Penalty, contemplate that certain transactions are entered in to by participants in the ordinary course of their business in forms consistent with customary commercial practice and are properly allowable under the Code.[37] Those transactions are not subject to the registration requirements under Section 6111, if the promoter reasonably determines that there is no reasonable basis under federal tax law for the IRS to deny any significant portion of the expected federal income tax benefits from the transaction.[38] Arguably, this is true for tax-exempt bonds, given the nature of the unqualified opinions rendered by bond counsel, as well as the specific statutory authority for the exclusion of interest under Section 103 of the Code. While the applicable reasonable-basis standard for the determination by the promoter is a relatively high standard that is significantly higher than the "not frivolous" standard or the "not patently improper" standard, it is lower than the standard applicable to "unqualified" opinions.[39] Such opinions regarding the validity and tax exemption of bonds are rendered by bond counsel only if bond counsel is firmly convinced (i.e., has a high degree of confidence) that, under the law in effect on the date of the opinion, the highest court of the relevant jurisdiction, acting reasonably and properly briefed on the issues, would reach the legal conclusions stated in the opinion.[40] Interestingly, this "reasonable basis" standard is the standard used by the new proposed regulations in defining the term "material Federal tax issue," which, as stated above, is defined as any federal tax issue for which the IRS has a reasonable basis for a successful challenge. Moreover, as stated above, the definition may form the basis for an argument that if an opinion concludes there are no "material Federal tax issues," as an "unqualified" opinion should by definition conclude, it is therefore not required to recite all relevant facts and law and relate the two in making its ultimate conclusions. Accordingly, the impact of the new tax shelter opinion standards on traditional tax-exempt bond opinions may actually be negligible.

The new proposed tax shelter opinion standards will likely require refinement by Treasury in the context of tax-exempt bond opinions. Arguably, without refinement the proposed standards (1) limit the ability to rely on the opinions of others in rendering one's own opinion, (2) require a detailed statements of fact and law in addition to legal conclusions and (3) require disclosure that the opinion affords no protection to those relying on it from a seemingly inapplicable penalty. After adequate consideration by the tax-exempt bond marketplace, a cost may temporarily be assigned to such opinions by market participants while the industry and marketplace standards are established, which could occur before the publication of this article.[41] Given the high standards of competence and accountability of tax practitioners who give opinions on tax-exempt bonds, the consensus based standard will serve the interest of the public, including the municipal bond marketplace.

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2 REG-122379-02; 249 DTR GG-2, L-6 (Dec. 30, 2003).

3 *See generally* Model Bond Opinion Report, Committee on Opinions and Documents, National Association of Bond Lawyers (Feb. 14, 2003) (providing guidance to lawyers rendering opinions in public finance transactions).

4 31 U.S.C. § 330; 31 C.F.R. pt. 10.

5 49 Fed. Reg. 6719 (1984).

6 31 C.F.R. § 10.33(c)(2) (Feb. 23, 1984).

7 66 Fed. Reg. 3276 (2001).

8 *Id*. at 3279.

9 *Supra* note 2.

10 Susanna D. Barnett, *Treasury Official Explains Changes in Circular 230*, The Bond Buyer, Feb. 4, 2004, at 5 (quoting Jonathan Ackerman, Attorney Advisor, Office of Tax Policy, Treasury).

11 Susanna D. Barnett, B*onds Could Fall Under Shelter Regs*, The Bond Buyer, Jan. 26, 2004, at 1 (quoting Pamela Olson, Assistant Treasury Secretary for Tax Policy, Treasury).

12 Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, 103 Stat. 2106.

13 I.R.C. § 6700(a)(2) (flush language). Treasury has recently announced a series of legislative proposals included in the President's FY '05 Budget that are designed, among other things, to halt abusive tax avoidance transactions, including a proposal to increase the penalties for false or fraudulent statements made to promote abusive tax avoidance transactions. Specifically, the Administration's proposal would increase the penalty up to 50 percent of the fees earned by the person making or furnishing the false statement in connection with the promotion of an abusive transaction. Release: Treasury Announces New Budget Proposals - New Proposals Close Loopholes, Stop Abusive Tax Avoidance Transactions, and Reduce Burdens on Taxpayers, Off. Pub. Aff., Treas. Dept. (Jan. 13, 2004).

14 H.R. Rep. No. 101-247, at 1397 (1989) (the "1989 House Report").

15 *Id*. at 1397, 1398. *See also* General Accounting Office Report, Improvements for More Effective Tax-Exempt Bond Oversight, GAO/GGD-93-014 (May 10, 1993) (recommending that the Internal Revenue Service tax-exempt bond compliance program "test use of the [Section 6700] penalty for promoting abusive tax-shelters in tax-exempt bond enforcement").

16 1989 House Report, *supra* note 14, at 1397-1398.

17 TriBar Opinion Committee, Third-Party "Closing" Opinions, 53 Bus. Law. 592, 610 (1998) (the "1998 TriBar Opinion Report").

18 *Id*.

19 Prop. 31 C.F.R. § 10.35(a)(1) (Dec. 30, 2003).

20 Prop. 31 C.F.R. §§ 10.35(a)(2)(i), (ii) (Dec. 30, 2003).

21 Prop. 31 C.F.R. § 10.35(a)(3) (Dec. 30, 2003).

22 Prop. 31 C.F.R. § 10.35(a)(4) (Dec. 30, 2003).

23 I.R.C. § 6662(d). *But see* Treas. Reg. § 1.6662-4(g)(2) (providing guidance under the former "principal purpose" standard of Section 6662(d) of the Code that tax-exempt bonds are on the so-called "angels list" for Section 6662(d) of the Code specifically discussed hereinafter).

24 Prop. 31 C.F.R. § 10.35(d)(2) (Dec. 30, 2003).

25 Prop. 31 C.F.R. § 10.35(b)(1) (Dec. 30, 2003) (providing that "[t]he practitioner must be knowledgeable in all aspects of Federal tax law relevant to the opinion being rendered. If the practitioner is not sufficiently knowledgeable to render an informed opinion with respect to particular material Federal tax issues, the practitioner may rely on the opinion of another practitioner with respect to these issues unless the practitioner knows or should know that such opinion should not be relied on.").

26 *Id*.

27 *See generally* Commentary, Model Opinion, General Obligation Bonds, *supra* note 3.

28 *See* Treas. Reg. § 1.148-2(b)(2)(i) (providing that an issuer's good faith expectations as of the issue date must be certified in a certification that states the facts and estimates that the form the basis for the issuer's expectations and such certification does not establish any conclusions of law or any presumptions regarding the issuer's actual expectations or their reasonableness). *See also* 1998 TriBar Opinion Report, *supra* note 17, at 612.

29 Committee on Legal Opinions, Legal Opinion Principles, 53 Bus. Law. 831, 833 (1998).

30 *E.g.*, "It is our opinion . . . that the interest on the Bonds *is* excludable from the gross income of the owners for federal income tax purposes under the statutes, regulations, published rulings, and court decisions existing on the date of this opinion." (emphasis added).

31 1998 TriBar Opinion Report, *supra* note 17, at 600-601.

32 *Id*. at 606-607.

33 Prop. 31 C.F.R. § 10.35(c)(7) (Dec. 30, 2003).

34 The Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788, § 1028(c)(2) (amending Section 6662(d)(2)(C)(iii) of the Code by striking "the principal purpose" and inserting "a significant purpose"). The amendment conformed the definition of tax shelter for purposes of the substantial understatement penalty to the definition of tax shelter for purposes of the then new confidential corporate tax shelter registration requirements at Section 6111(d) of the Code. Staff of the Joint Comm. on Taxation, 105th Cong., 1st Sess., General Explanation of Tax Legislation Enacted in 1997, 224 (1997).

35 Treas. Reg. § 1.6662-4(g)(2)(i).

36 *Id*. at (2)(ii).

37 Treas. Reg. §§ 301.6111-2(b)(3)(i), (ii).

38 Treas. Reg. §§ 301.6111-2(b)(1), (3)(i), (3)(ii), (4)(i).

39 *Id*. at (4)(i) and Treas. Reg. § 1.6662-3(b)(3).

40 Commentary, Model Opinion, General Obligation Bonds, *supra* note 3 (citing Glazer and Fitzgibbon on Legal Opinions, 71-74 (Aspen Law & Bus. 2d ed. 2001)).

41 *See* Prop. 31 C.F.R. § 10.35(f) (Dec. 30, 2003) (providing that the effective date of the new tax shelter opinion standards is the date that the final regulations are published in the Federal Register). *But see* IRS Announcement 2004-29, 2004-15 I.R.B. (Apr. 12, 2004) (announcing "that, in final regulations, the definition of tax shelter opinion for purposes of [31 C.F.R. § 10.35] will not apply, *if at all*, to written advice concerning municipal bonds rendered less than 120 days after publication of such final regulations in the Federal Register." (emphasis added)).

CHANGING THE DOMICILE OF A DISREGARDED ENTITY UNDER AN "F" REORGANIZATION

by Martin M. Van Brauman[1]

With the increased use of disregarded entities created by the check-the-box regulations or through the "qualified Subchapter S subsidiary" ("QSub") election for subchapter "S" corporations, the need to move the domicile of a disregarded entity for various reasons may occur for either a regular corporation or an "S" corporation. The question arises as to whether a reorganization of a corporation that is disregarded for federal tax purposes would satisfy the corporate status requirement for a nontaxable reorganization under I.R.C. § 368(a).[2]

The following article addresses this question with a subchapter "S" corporation situation by discussing the effects of the QSub election and the treatment of a domicile change. For example, if a parent "S" corporation ("P"), a Nevada corporation, owns a "qualified Subchapter S subsidiary" ("QSub")("SM") incorporated in Michigan, could the domicile of the QSub change to Delaware for various business reasons in a nontaxable reorganization. The facts assume that certain businesses in Michigan would continue, but through a Delaware corporation "doing business" in Michigan.

Qualified Subchapter S Subsidiary ("QSub") Election

An "S" corporation may elect to treat a 100 percent-owned domestic corporation as a QSub.[3] The QSub election would be a deemed liquidation of the subsidiary into the parent corporation for federal tax purposes. If the election is effective at the time of incorporation of the QSub, the subsidiary would have never existed as a separate corporation for federal tax purposes. The QSub election permits the S corporation parent to treat the subsidiary as a nonentity for federal tax purposes, although the subsidiary is respected under state law. In the example, the QSub would exist under Michigan law as a state-law entity.

Sections 332 and 337 apply in determining the effects of the QSub election on an existing subsidiary. Section 332 provides for nontaxable treatment of the complete liquidation of a subsidiary into its parent corporation. Section 337 provides for nontaxable treatment on the distribution of property to the parent under a section-332 liquidation. For purposes of section 332, the making of a QSub election satisfies the requirement of adopting a plan of liquidation. The QSub election will not recognize income from any built-in gain assets. The built-in gain rules for an S corporation would apply to any subsequent disposition of those assets.

Since an "S" corporation cannot own another "S" corporation, P would have elected a QSub status for its subsidiary. All assets, liabilities and items of income, deduction and credit of a QSub are treated as assets, liabilities and such items of its parent. All inter-company transactions among a QSub, its parent S corporation, or other QSubs would be ignored. The transfer of property among QSubs and the parent would be ignored.

Changing the Domicile

The change of the domicile of S_M from Michigan to Delaware would fall under the form of an "F" reorganization. An F reorganization is defined in I.R.C. § 368(a)(1)(F) as "a mere change in identity, form, or place of organization of one corporation, however effected." Unlike the other types of reorganization, the F reorganization requirements are not specifically elucidated in the regulations under section 368. The essence of the tests for qualification as an F reorganization is that nothing else occur except for the change in identity, form or place of organization. The criteria as enunciated by the IRS states that the capital structure, assets, business and shareholders of a corporation must remain substantially unchanged by the F reorganization.

An "F" reorganization may occur with a liquidation-reincorporation transaction where there is a complete identity of proprietary interest.[4] Perhaps the most common type of F reorganization involves the reincorporation of a corporation in the same or a different state. A reincorporation can be accomplished by: (1) a merger of the transferor Oldco corporation into the transferee Newco corporation under state law; (2) a transfer by the Oldco shareholders of their Oldco stock to Newco in exchange for the newly issued stock of Newco, followed by a liquidation of Oldco into Newco; or (3) a transfer by Oldco of all of its properties to Newco in exchange for the newly issued Newco stock, followed by a distribution of the Newco shares by Oldco to its shareholders in liquidation.

The domicile change of S_M, a Michigan corporation, to S_D, a Delaware corporation, in this situation would follow the liquidation-reincorporation procedures. Michigan laws do not contain conversions statutes. Also, the Michigan merger statutes do not apply for an outbound change of domicile. Irrespective of the formal steps taken to effect the transaction, all reincorporations are treated in the same manner for federal tax purposes.

Pursuant to the incorporation in Delaware, P transfers 100% of the stock of S_M in exchange for 100% of S_D stock. Since S_M is a QSub, the transaction is treated as a transfer of assets and liabilities of S_M by P to S_D. The capital structure, assets, the business and shareholders remain unchanged before and after the transfer from S_M to S_D.

Upon the incorporation of S_D, P elects QSub treatment effective upon the incorporation date by filing Form 8869. There is no recognized gain on the transfer between the old QSub and the new Qsub, since the transfer of assets and liabilities in exchange for stock is disregarded for tax purposes.[5] S_M and S_D would not be treated as separate corporations at any time.

All assets, liabilities and items of income, deduction and credit of a QSub are treated as assets, liabilities and such items of the S corporation.[6] The stock of a QSub is disregarded for all federal tax purposes, except for purposes of satisfying the 100 percent stock ownership requirement to be eligible to make the QSub election under section 1361(b)(3)(B)(i).[7] Thus, all inter-company transactions among a QSub, its parent S corporation, or other QSubs would be ignored. Loans, the sale or transfer of property, distributions of property among QSubs and/or the parent would be ignored.[8]

The tax treatment of a larger transaction that includes a liquidation is determined under the Internal Revenue Code and general principles of tax law, including the step transaction doctrine.[9] If an S corporation forms a subsidiary and makes a valid QSub election (effective upon the date of the subsidiary's formation) for the subsidiary, there will be no deemed liquidation of the new subsidiary. Instead, the deemed transfer of assets to the Delaware corporation and the deemed liquidation are disregarded and the Delaware corporation will be deemed to be a QSub from its inception.

The dissolution under the Michigan statutes of the S_M will terminate its QSub election and S_M will reincorporate into S_D pursuant to the form of an "F" reorganization. S was liquidated into its parent corporation, P, under Michigan state law procedures. The state law liquidation would terminate S's QSub election, but otherwise the state law liquidation is ignored for federal tax purposes. Since P already owns the assets for federal tax purposes, P can direct the transfer of the assets of S to any other QSub "doing business" in Michigan without any federal tax effect.

An "F" reorganization occurs with a liquidation-reincorporation transaction where there is a complete identity of proprietary interest. S_M is treated simply as moving its domicile from Michigan to Delaware. The transferee S_D is treated as acquiring the assets of the transferor S_M in exchange for the issuance of S_D stock and the assumption of S_M 's liabilities.[10] The surviving corporation, S_D, would use the same tax identification number previously assigned to the transferor corporation, S_M, since the surviving corporation and the transferor corporation are treated as the same corporation for federal tax purposes in a F reorganization.[11]

S_M would liquidate as a Michigan corporation by filing a Certificate of Dissolution. The new Delaware company would file for a Certificate of Authority to Transact Business or Conduct Affairs in Michigan as a foreign corporation. P would elect QSub status for the Delaware company effective upon the Delaware incorporation date. There is no recognized gain on the transfer between the old QSub and the new Qsub, since the transfer of assets and liabilities in exchange for stock is disregarded for tax purposes. The QSub will not be treated as a separate corporation.

Section 1.1361-5(b)(1) provides that the tax treatment of a QSub termination or of a larger transaction that includes the termination will be determined under the Internal Revenue Code and general principles of tax law, including the step transaction doctrine. The surviving Delaware corporation will use the same tax identification number previously assigned to the Michigan corporation, since the surviving corporation and the transferor corporation are treated as the same corporation for federal tax purposes under an "F" reorganization and step transaction principles.

Because at the end of the series of transactions, the assets continue to be held by Parent for federal tax purposes, under the step transaction principles, the formation of the Delaware corporation and the transfer of assets pursuant to a "F" reorganization are disregarded. However, the transaction must satisfy still the requirements of an "F" reorganization, which is an exception to the QSub being disregarded as a corporation. The QSub is treated as a corporation involved in the "F" reorganization, if the transaction otherwise satisfies the requirements of section 368(a)(1)(F).[12]

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2 Except as noted, all statutory and section references herein are to the Internal Revenue Code of 1986 (26 U.S.C.), as amended, and all regulation references are to the U.S. Treasury Regulations.

3 The parent S corporation uses Form 8869 to elect to treat one or more of its eligible subsidiaries as a qualified subchapter S subsidiary. The election form (Form 8869) must be signed by a person authorized to sign the parent's S corporation return required to be filed under section 6037. Form 8869 would be filed with the Service Center where the subsidiary filed its most recent return. The Service Center will notify the S corporation of its determination of acceptance of the election generally within 60 days after Form 8869 is filed (date mailed). The QSub would retain its same employer identification number ("EIN").

4 Pridemark, Inc. v. Commission, 42 T.C. 510 (1964), *aff'd in part and rev'd in part*, 345 F.2d 35 (4th Cir. 1965).

5 Treas. Reg. § 1.1361-5(a)(4), Ex. 3.

6 I.R.C. § 1361(b)(3)(A)(ii); Treas. Reg. § 1.1361-4(a)(1)(ii).

7 Treas. Reg. § 1.1361-4(a)(4).

8 *See* Treas. Reg. § 1.1361-4(d), Ex. 4.

9 Treas. Reg. § 1.1361-4(a)(2)(i).

10 Priv. Ltr. Rul. 2003-200-13(February 4, 2003).

11 Rev. Rul. 73-526, 1973-2 C.B. 404.

12 *See* Treas. Rev. § 1.1361-5(b)(1).

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