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CHAIR'S MESSAGE

I hope this message finds you well.

In my past messages, I explained how our members can get involved in Section activities by participating in regulatory commenting projects and in the production of CLE. In this message, I want to highlight what the Section is doing in the area of pro bono activities.

As you may know, one of the goals of the Section is to work towards delivering the knowledge and experience of its members to those people who cannot afford the services of tax lawyers. We are accomplishing this goal under the capable leadership of Janet Jardin (janet.jardin@tklaw.com). Janet is the Chair of our Pro Bono Committee.

Our Pro Bono Committee presently has two avenues for delivering these vital pro bono services. The first is through the Section's participation with Texas C-Bar (www.texascbar.org). Texas C-Bar provides free legal assistance to Texas nonprofit organizations that are working to improve the quality of life in low-income neighborhoods. Through Texas C-Bar, transactional lawyers are able to assist those nonprofit organizations with their real estate, tax, corporate, and employment law concerns.

The second avenue our Pro Bono Committee has for delivering pro bono services is through our work with the Volunteer Income Tax Assistance (VITA) Program. Through the VITA Program, Section members can offer free tax help to low- to moderate-income people who are unable to prepare their own tax returns.

I really hope you will consider getting involved with the Pro Bono Committee. Participating in the activities of the Pro Bono Committee is a great way to use your specialized talents in the area of tax law to help meet the needs of those who are less fortunate. If you're interested in getting involved with the Pro Bono Committee or any of the Section's other Committees, please contact the Chair of the Committee you wish to join. The contact information for the Committee Chairs is found on page 22 of the *Texas Tax Lawyer*.

Turning to other matters, I strongly encourage you to attend the *23rd Annual Texas Federal Tax Institute* at the Hyatt Hill Country Resort and Spa in San Antonio. The program will be held on June 7 and 8, 2007 and should be excellent. More information on the program is available at www.clesolutions.com.

Another meeting I strongly encourage you to attend is the Annual Meeting of the State Bar of Texas, which will be held in San Antonio, Texas on June 22, 2007. The brochure describing the Section's activities at the Annual Meeting is found on page 5 of the *Texas Tax Lawyer*. One item I would like to call your attention to is that the Tax Section members will vote on the in-coming members of the Council of the Section at the Annual Meeting. The Nominating Committee (made up of Robert Gibson, Jack Taylor, and David Wheat) has recommended that Larry Jones, Geoffrey Polma, and Stephanie Schroepfer be appointed to the Council. Don't forget to cast your vote.

Speaking of the Council, I want to extend a special thank you to Christi Mondrik, Elizabeth Copeland, and G. Walter McCool, the three Council members whose terms are expiring this year. You three have done terrific work.

Finally, I want to mention that, on April 18, 2007, the Council elected the following persons to serve as officers for the 2007-2008 year:

Chair-Elect	Daniel J. Micciche
Secretary	Tyree Collier
Treasurer	Patrick O'Daniel

These officers will serve alongside Kevin J. Thomason, who will be the Chair of the Tax Section for the 2007-2008 year. Congratulations, Daniel, Tyree and Patrick!

Once again, thanks for all you do.

Gene Wolf, Chair

ANNUAL MEETING EVENTS
STATE BAR OF TEXAS TAX SECTION

JUNE 22, 2007

Henry B. Gonzalez Convention Center
San Antonio

PROGRAM:

9:00 a.m. – 10:00 a.m. **Texas Franchise Tax Update: Navigating the New Margin Tax Calculation -**
Jerry Oxford, Texas Comptroller of Public Accounts, Franchise Tax Section, Tax Policy and
Christi Modrik, Martens & Associates

10:00 a.m. – 10:15 a.m. Morning Break

10:15 a.m. – 11:15 a.m. **Estate Tax: Litigating When the Best Plans Go Awry –**
Honorable Juan Vasquez, United States Tax Court,
T. Richard Sealy, Associate Area Counsel, SB/SE, Internal Revenue Service
Todd Welty, Meadows, Collier, Reed, Cousins & Blau, LLP

11:15 a.m. – 11:45 a.m. **Tax Section Annual Meeting**

11:45 a.m. – 12:00 p.m. Break

12:00 p.m. – 1:30 p.m. **Lunch with Legends: Question and Answers** with the
Honorable Juan Vasquez, United States Tax Court,
Stanley Blend, Oppenheimer & Blend, Harrison and Tate, Inc.;
Trey Cousins, Meadows, Collier, Reed, Cousins & Blau, LLP

3.5 Hours CLE Credits Requested
In order to receive **CLE credit**, please register for the Annual Meeting:
www.texasbar.com/annualmeeting

In order to attend the **Lunch with Legends**, please
e-mail: events@texastaxsection.org

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SECTION OF TAXATION OF THE STATE BAR OF TEXAS

2006-2007 CALENDAR

July	
August	
14	Deadline for submitting articles for the October 2006 issue of the *Texas Tax Lawyer*
September	
15	10:30 a.m. – 12:30 p.m. Council and Committee Chairs Meeting **MANDATORY IN PERSON ATTENDANCE** Akin Gump Strauss Hauer & Feld LLP 1700 Pacific, Suite 4100 Dallas, Texas 75201 (214) 969-2800
28-29	24th Advanced Tax Law Course – Dallas
October	
19 – 21	ABA Section of Taxation 2006 Joint Fall CLE Meeting – Denver, Colorado
November	
3	10:30 a.m. – 12:30 p.m. Council Meeting Akin Gump Strauss Hauer & Feld LLP 1700 Pacific, Suite 4100 Dallas, Texas 75201 (214) 969-2800
9-10	24th Advanced Tax Law Course – Houston (Video)
December	
11	Deadline for submitting articles for the February 2007 issue of the Texas Tax Lawyer
January	
18 – 20	ABA Section of Taxation 2007 Midyear Meeting – Hollywood, Florida
26	10:30 a.m. – 12:30 p.m. Council and Committee Chairs Meeting Akin Gump Strauss Hauer & Feld LLP 1700 Pacific, Suite 4100 Dallas, Texas 75201 (214) 969-2800
February	

March	
12	Deadline for submitting articles for the May 2007 issue of the *Texas Tax Lawyer*
April	
20	10:30 a.m. – 12:30 p.m. Council Meeting Akin Gump Strauss Hauer & Feld LLP 1700 Pacific, Suite 4100 Dallas, Texas 75201 (214) 969-2800
May	
10	Deadline for SBOT Annual Meeting “early bird” registration and hotel reservations
10 – 12	ABA Section of Taxation 2007 May Meeting – Washington, DC
June	
7-8	23rd Annual Texas Federal Tax Institute – San Antonio
21-22	State Bar of Texas Annual Meeting – San Antonio
22	Members’ Meeting of the Section of Taxation of the State Bar of Texas – San Antonio
July	**Future Dates - Tentative**
July 26	Orientation for SBOT Section chairs/vice-chairs, treasurers and Committee chairs/vice-chair

23rd Annual Texas Federal Tax Institute

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Tax Accounting Issues in Corporate Transactions
– Glenn Carrington & Amy Sargent

Selected Tax Issues in Private Equity Transactions
– Kevin Keyes

Update on Tax-Free Spin-Offs
– Julie Divola

Current Developments in Tax-Free Corporate Reorganizations
– Deborah Paul

Consolidated Return Issues (including LDR update)
– Michael L. Schler

The Bleeding Edge of Section 1031
– Louis S. Weller

The New Texas Margin Tax: Recent Developments and Open Issues
– Daniel J. Micciche, Cynthia Ohlenforst, Geoffrey Polma

… AND MANY MORE!

FEATURED FRIDAY LUNCH SPEAKER:

Eric Solomon — Acting Deputy Assistant Secretary of the Treasury (Tax Policy), U.S. Treasury Department

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SPECIAL RECOGNITION AWARD FOR EXCELLENCE IN TAX LAW

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1953-2006

Ron Kalteyer passed away unexpectedly on December 16, 2006. Ron was a partner at Locke Liddell & Sapp LLP and practiced at the highest levels of the tax profession for more than 25 years.

He was an active member of the tax bar, tax professor and frequent author and speaker on tax matters. The Texas tax bar has lost a valued colleague, friend and outstanding lawyer.

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THE ABCS OF THE THREE Rs: REBATE REFUND REQUESTS

Wm. Mark Scott[1]
Washington, D.C.

This article addresses federal tax issues relating to state and local governmental bond issuers and their conduit borrowers who have paid arbitrage rebate, but discover that they paid too much or are due a refund because of negative arbitrage in later periods. This article answers questions concerning refund filings. Questions such as: when and where one should file, what form one should use, and whether filing a refund request increases the chance of an audit. This article will analyze the history of rebate refunds, provide insights into the current processes for seeking a rebate refund, and warn about potential pitfalls and legal issues.

Overview

Congress requires issuers to make payments of arbitrage rebate on a regular basis in order to preserve the tax-exempt status of their municipal obligations.[2] Payments of arbitrage rebate are generally made once every five years, and after the last bond is retired.[3] A rebate payment is made when it is filed with the Internal Revenue Service ("IRS") at the place designated by the Commissioner and accompanied with the Form 8038-T, "Arbitrage Rebate."[4]

The IRS has no rights to assess rebate or to take any collection activities to recover rebate from the issuer.[5] If the issuer fails to timely pay arbitrage rebate, the IRS's remedy is to tax bondholders on the interest income they received on the bonds. The IRS is required to tax bondholders through use of the normal deficiency procedures applicable to all taxpayers.[6]

Under current law, an issuer may seek the refund of an overpayment of arbitrage rebate by establishing to the satisfaction of the Commissioner of Internal Revenue that an overpayment has occurred.[7]

The History of Rebate Refund Requests

Arbitrage rebate has not always been refundable.[8] In the early years of the program, it was believed that, by requiring issuers to pay only 90 percent of the amount due every five years, there would be few instances when a refund would be necessary.[9] Therefore, the earliest discussions within the IRS and the Treasury Department focused on when, if ever, rebate refund requests would be allowed.[10]

In 1989, a compromise was reached to allow refunds, but only upon "mistakes," which were mostly regarded as being limited to "mathematical" mistakes.[11] It was not until the 1993 regulations that the refund provisions were expanded to allow for refunds for all purposes.[12] Soon thereafter, refund requests exploded both in number of requests and size of refunds requested.[13]

By 1994, the IRS examination function was beginning to slowly evolve and become a factor in the municipal marketplace.[14] Early enforcement seminars often focused on the question of whether or when an examination would be initiated based on a request for a refund of arbitrage.[15] Also, during this early period of IRS examination activity, Washington-based personnel made a startling discovery - rebate payments were not being processed onto IRS computers, and Forms 8038-T were sitting in boxes, some with checks still attached.[16] To complicate matters, the IRS was not inputting payments into a system that could tie a refund request to an earlier payment, and rebate claims were not being worked on on a timely basis.[17]

Standup of the Office of Tax Exempt Bonds occurred in early 2000.[18] By then, the IRS was well on its way to developing a methodology to capture rebate payments in the IRS computer system.[19] This task was completed soon after standup. Once the method of capturing payments was completed, the IRS reinvigorated its efforts to speed up the process of resolving rebate claims.[20]

In 2000, the average time to refund a rebate payment was well over a year after the request was received. Because the IRS does not pay interest on rebate refunds, it was determined that the period of time to refund payments should be accelerated.[21] To accomplish this task, dedicated staff were trained and assigned to work rebate refund requests, and these returns were provided priority over regular examination activities.

Nevertheless, delays and confusion still persisted. To reduce delays, the IRS designed and published a special form for rebate refund requests, the Form 8038-R, "Request for Recovery of Overpayments Under Arbitrage Rebate Provisions."[22] By using a special form, the processing of requests from the IRS Service Centers to the examination review function was quickened.

In 2006, the Office of Tax Exempt Bonds informally moved the function of rebate refund request review from the field offices to Washington.[23] Currently, three employees in Washington review all arbitrage rebate refund requests.[24]

Current Refund Process

An "overpayment" of arbitrage rebate is defined as the excess of the amount paid to date as arbitrage rebate, less the amount owed as of the most recent computation date.[25] A request for a refund of an overpayment of arbitrage rebate is filed on the Form 8038-R, "Request for Recovery of Overpayments Under Arbitrage Rebate Provisions."[26] The issuer files its request with the IRS Service Center in Ogden, Utah.[27]

IRS regulations require the Form 8038-R to be signed by the issuer, even when the bond proceeds are lent to a conduit borrower.[28] Issuers are generally advised by the IRS to forward their computations with their refund requests.[29] Further, because refund requests are being subjected to 100 percent review at this time, sending in documentation (such as the rebate report and offering statement) with refund requests avoids having to send in those documents upon a later request and may ultimately speed the processing of the refund.

As before, there are no guarantees that a refund request will not result in a referral of the bond issue to the examination function.[30] The persons reviewing filed requests have significant experience in identifying arbitrage issues. If an issuer is concerned about the chances of an audit, it would be well advised to seek a professional review of its request prior to submission.

If an issuer is unable to resolve its claim with the IRS Office of Tax Exempt Bonds, it can seek a review of the denial by requesting an independent review by the IRS Office of Appeals.[31] In certain instances, issuers can also seek review of any legal issues involved in its claims by requesting "technical advice" from the IRS Office of Chief Counsel.[32] Lastly, if all of these options are exhausted, or if the issuer simply chooses to skip one or more of these processes, it can file for a refund with a court of law.[33]

What an Advisor Needs to Know

Certain common legal issues have arisen with respect to claims for rebate refund. One of the most common is whether the recipient is entitled to compensation for the time value of money.

> Assume an issuer makes a payment of $100,000 in arbitrage rebate at the end of year 5. Under the rebate "future value" system, this rebate payment has grown to equal a credit of $135,000 by year 10. Assume the year 10 rebate calculation shows total rebate due on the issue of $95,000, with a net rebate liability of ($40,000). Can the issuer submit a refund request for $40,000 ($135,000 less $95,000), or is the refund limited to $5,000 ($100,000 less $95,000)?

The answer to this question is complicated by conflicting messages in the 1993 Arbitrage Regulations.[34] Attempts to clarify this language have, unfortunately, led to further misinformation and inconsistent treatment.[35] The inconsistent treatment is due, in large part, to conflicts between the IRS Office of Chief Counsel and the IRS Office of Appeals.[36] After becoming aware of these conflicts, the IRS Office of Tax Exempt Bonds sought further guidance and, in the interim, informally determined to refund requested overpayments consistent with Example 2 of the regulations, with one proviso, that the total amount of refunds cannot exceed the total amount paid in as arbitrage rebate.[37] Therefore, in this example, the IRS would refund $40,000 to the issuer.[38]

Another common legal issue, and perhaps the biggest trap for the unwary in this process, concerns when an issuer must file its suit in a court of law to protect its rights to a judicial review of its refund claim. Generally, government officials are not authorized to refund rebate payments if the claim is not filed within a six year statute of limitations applicable to claims against the government.[39] The IRS has used this statute to deny a request filed more than six years after the retirement of the bonds.[40]

On the other hand, the IRS has informally agreed to process refund requests submitted before six years after the last bond is retired, based on legal advice from the IRS Office of Chief Counsel.[41] This very lengthy timeline is, however, deceiving. Although generally favorable for issuers, the IRS analysis that permits it to review claims many years, if not decades, after the initial payment of rebate, should not be assumed to be correct.[42] Issuers should, instead, protect their rights to a refund by filing a claim with the U.S. Court of Federal Claims within six years of the earlier of the following dates: the date the issuer made a rebate payment by mistake, or the date they are aware of the right to a refund due to negative arbitrage.[43]

> Assume the issuer makes a rebate payment in year 5, then in year 10 receives a second arbitrage rebate report that indicates the year 5 payment was made in error. The issuer files a claim for refund (Form 8038-R) with the IRS in year 11, but the IRS does not begin working the claim until year 12. Upon a denial of its claim in year 12, the issuer files a claim for refund in the U.S. Court of Federal Claims.[44] Because the year 5 payment was made in error, is the claim to the U.S. Court of Federal Appeals in year 12 timely?

Although no court has ruled on the application of the six-year statute of limitations to the arbitrage rebate refund process, the issuer in the above example is running a significant risk that its claim will not be heard by a court of law as it was filed more than six years after its mistaken payment.

Conclusion

The IRS has worked hard to improve the process for refund overpayments of arbitrage rebate and we should be thankful for their continued efforts in this respect. Nevertheless, issuers and borrowers should be cautious about requests that highlight potential examination issues, and for potentially allowing the time period for contesting a refund request to lapse.

ENDNOTES

1 Vinson & Elkins, The Willard Office Building, 1455 Pennsylvania Avenue NW, Suite 600, Washington, DC 20004-1008, mscott@velaw.com
2 I.R.C. § 103, 148(f).
3 I.R.C. § 148(f)(3).
4 Treas. Reg. § 1.148-3(g).
5 *See City of Galt v. United States*, 804 F. Supp. 1275, 1278 (E.D. Cal. 1992) (wherein the Court found, in part, that "the arbitrage payment is not itself a tax.").
6 I.R.C. §§ 6211-6215.
7 Treas. Reg. § 1.148-3(i)(1).
8 *See* former Treas. Reg. § 1.103-15AT(e)(3) (1985).
9 I.R.C. § 148(f) requires "installment payments" to be made at least once every five years in an amount equal to 90 percent of the total potential rebate payment. The final rebate payment is due shortly after retirement of the bonds.
10 The author worked in the Office of Chief Counsel in the late 1980's and was assigned responsibility for working with the Office of Treasury on the development of the 1989 Arbitrage Regulations.
11 The preamble to the 1989 Temporary Regulations provided that "[r]ebate payments are not refundable. However, it is anticipated that the regulations will provide that issuers generally may recover overpayments if . . . the excess was paid as a result of a mistake (e.g., a mathematical error)." A similar rule was carried over into later regulations. Treas. Reg. § 1.148-13T (1992). *See Galt*, 804 F. Supp. at 1277-8.
12 Treas. Reg. § 1.148-3(i)(1) provides that an issuer may recover an overpayment simply by establishing to the satisfaction of the Commissioner of Internal Revenue that an overpayment occurred. Rev. Proc. 92-83, 1992-2 C.B. 487, provided the initial procedures for requesting an overpayment refund.
13 By 2002, almost 100 refund requests per year were being worked by the Office of Tax Exempt Bonds.
14 The examination function for bonds was an outgrowth from the GAO report of 1993, "Tax Policy and Administration: Improvements for More Effective Tax-Exempt Bond Oversight," GAO/GGD-93-104. The official announcement of a consolidated IRS audit program for municipal bonds was made in Announcement 93-92, 1993-24 I.R.B. 66.
15 Early Internal Revenue Manual ("IRM") provisions did not preclude the use of a rebate refund filing as a basis for the institution of an examination of the bond issue.
16 Rebate payments and Forms 8038-T were initially mailed to the IRS Service Center in Philadelphia, PA. The processing of arbitrage rebate payments and claims was officially transferred to the Ogden Service Center in the Spring of 1998. Notice 2005-32, 2005-28 I.R.B. (July 11, 2005), officially changed the

place of filing for rebate returns filed pursuant to the 1989 or 1992 rebate regulations. Processing of examinations of rebate claims were initially posted onto the IRS NMF systems. *See* TIGTA Report 2000-10-047 (March 2000), and IRM § 4.81.1.9.1(2).

17 In 1994, the IRS discovered more than a dozen pending claims in the Philadelphia Service Center, some of which were close to three years old.

18 The office was officially created in 1999, but the selection of the Director and key personnel were not made until March 2000.

19 As an indicator of the size of this problem, rebate payments in 1999, 2000, and 2001 totaled approximately $258,180,000, $172,120,000, and $66,030,000, respectively.

20 Refunds of arbitrage rebate generally do not include compensation for the time value of money. (See discussion under "What Your CPA Needs to Know," below.)

21 The IRS does not treat the payment of rebate as a payment of tax. Under this analysis, the refund of an overpayment is not entitled to the overpayment rate of interest per IRC § 6611. *See Galt*, 804 F. Supp. at 1278.

22 Announcement 2001-115, 2001-48 I.R.B. 539, formally announced the availability of the Form 8038-R, "*Request for Recovery of Overpayments Under Arbitrage Rebate Provisions*."

23 Former procedures required only claims in excess of $1,000,000 to be reviewed in the Washington office. IRM §§ 4.81.1.27(1)d and 4.81.1.8.1(7).

24 Michael Muratore, Christopher Woodin, and Jyoti Athavale.

25 Treas. Reg. § 1.148-3(i). In addition, this provision further limits recoveries by providing that an overpayment will not be approved to the extent that a recovery on the date the refund is requested would result in having an additional rebate liability as of that date.

26 Announcement 2001-115, 2001-48 I.R.B. 539 (Nov. 26, 2001).

27 Instructions to Form 8038-R.

28 Treas. Reg. § 1.148-1(b) defines "issuer" to include conduit borrowers, except with respect to provisions "regarding elections, filings, liability for the rebate amount, and certifications of reasonable expectations."

29 Form 8038-R, Line 17 and instructions thereto.

30 Per IRM § 4.81.1.8.1(6), opening an examination of a claim for matters beyond verifying correctness required approval by the Field Operations Manager. It is unclear under current processes whether or how this requirement is being implemented.

31 Section 3.01 of Rev. Proc. 2006-40, I.R.B. 2006-42.

32 Section 3 of Rev. Proc. 2007-2, I.R.B. 2007-1.

33 The provisions of I.R.C. §§ 6532(a) and 7422(a) do not technically apply to claims for refunds of arbitrage rebate. No provisions of the Code or regulations require the filing of a claim prior to the filing of a suit. *See* Tech. Adv. Mem. 2004-46-021 (Aug. 6, 2006), in which the Service found that "no periods of limitations existed for the prescribed refund procedures that was distinct from the period of limitations if Issuer *had chosen to forego the administrative refund process*." (italics added.)

34 *Compare* the wording of Treas. Reg. § 1.148-3(i)(1) with the illustration thereof in Example 2, part (iii)(D) of the regulations (which implies that an issuer would be entitled to a refund of the future value of its payment).

35 Tech. Adv. Mem. 2000-51-001 (Jun. 15, 2000).

36 Appeals' case resolution memorandums are not available for public review.

37 *See* ILM 200512019 (Feb. 16, 2005).

38 Section 148(f)(5) of the Code excludes the payments of rebate from gross income. Therefore, under general tax principles, it is likely that the return of said payments should be treated as gross income in the year of receipt for most taxable conduit borrowers.

39 28 U.S.C. §§ 2401, 2501.

40 Tech. Adv. Mem. 2004-46-021 (Aug. 6, 2004).

41 The IRS interpretation was based on an analysis of common law rules relating to claims, as opposed to the treatment of the installment payments as tax deposits versus tax payments. *See Rosenman v. U.S.,* 323 U.S. 658 (1945).

42 Every claim is time-barred unless the petition to the court arrives within six years of the date the claim first accrues. *Kinsey v. U.S.*, 852 F.2d 556, 557 (Fed.Cir.1988). This jurisdictional requirement is a condition of the government's waiver of sovereign immunity and, as such, is strictly construed. *Hopland Band of Pomo Indians v. U.S.*, 855 F.2d 1573, 1576-7 (Fed.Cir.1988). This statute of limitations cannot be waived by government agents. *Mentis v. U.S. Postal Service*, 547 F. Supp. 164, 166 (W.D.N.Y. 1982).

43 Rebate claims are subject to a six-year statute of limitations. 28 U.S.C. §§ 2401, 2501; Tech. Adv. Mem. 2004-46-021 (August 6, 2004). The first date of this statutory period is based on common law rules relating to when all events fix the government's alleged liability have occurred and the claimant was or should have been aware of the government's liability. *General Instruments Corp. v. U.S.*, 33 Fed. Cl. 4, 7-8 (1995). For restitutions based on payments by mistake, courts generally regard the statutory period to begin to run when the payment is made. *See Norwest Bank Minn. Nat'l Ass'n. v. Federal Deposit Ins. Corp.*, 312 F.3d 447 (D.C. Cir. 2002). A refund claim filed with the Office of Tax Exempt Bonds does not stay the running of the statute of limitations. Rev. Rul. 57-242, 1957-2 C.B. 452.

44 Generally, the U.S. Court of Federal Claims will have sole jurisdiction over most rebate refund claims. *Compare* 28 U.S.C. § 1491 (jurisdiction of U.S. Court of Federal Claims) with 28 U.S.C. § 1346 (jurisdiction of U.S. District Courts) in light of conclusion that rebate payments are not "tax" payments.

TEXAS PROPERTY TAX LAW DEVELOPMENTS

John Brusniak, Jr.[1]
Dallas, Texas

OWNERS, WRONGFULLY OMITTED FROM DELINQUENT TAX FORECLOSURE SUITS, MUST SUE TO SET ASIDE FORECLOSURE JUDGMENT WITHIN ONE YEAR OR PAY TAXES IN THE INTERIM TO EXTEND THE LIMITATIONS PERIOD; THIS STATUTORY REQUIREMENT IS CONSTITUTIONAL AS IS THE PROVISION REQUIRING A CHALLENGING PARTY TO DEPOSIT THE CONTESTED TAX AMOUNTS INTO THE REGISTRY OF THE COURT AS A CONDITION PRECEDENT TO FILING SUIT.

John K. Harrison Holdings, LLC v. Strauss, No. 09-06-106-CV (Tex. App. –Beaumont, March 22, 2007, no pet. h.). (to be published).

A person purportedly took title to a lot from a prior owner by quitclaim deed in 2001. The property had been previously foreclosed by a taxing entity for nonpayment of property taxes in 1995 and a constable had conveyed title by tax sale deed to a third party in 1996. In 2003, the person sued to set aside the tax sale deed contending that the rightful owner had not been sued, or served with process, in the underlying tax foreclosure suit. The foreclosure purchaser defended on the grounds of limitations. The Tax Code provides that a person wishing to challenge a tax foreclosure must file suit within one year of the date on which a tax deed is recorded or pay taxes in the interim to toll the limitations period. The challenger is also required to deposit the contested tax amount into the registry of the court as a condition precedent to filing suit. The person in this suit did not comply with any of these provisions. As a result, the court held that the person did not have standing to contest the tax foreclosure deed. The person contended that these statutes were unconstitutional. The court disagreed, holding that these provisions were reasonable restrictions on the tax foreclosure challenge process, and as a result were valid.

ABSENT A CLAIM OF FRAUD, MUTUAL MISTAKE OF FACT OR DURESS, SOVEREIGN IMMUNITY BARS SUITS FOR RECOVERY OF ILLEGALLY COLLECTED PROPERTY TAXES.

Nivens v. City of League City, No. 01-05-00335-CV (Tex. App. –Houston [1st Dist.] January 18, 2007, no pet. h.). [to be published].

Taxpayers sued a city for “money had and received” and breach of contract for overcharging ad *valorem* taxes under collection agreements with several municipal utility districts. In its defense, the city claimed sovereign immunity. The court agreed, holding that a governmental entity may not be sued to obtain a refund of illegally assessed property taxes absent a claim of fraud, mutual mistake of fact, or duress. Since the taxpayers failed to raise any of these issues in their pleadings, they were not entitled to proceed with their suit.

ILLEGAL TAX FORECLOSURES CONSTITUTE INVERSE CONDEMNATION. INVERSE CONDEMNATION CLAIMS MUST BE BROUGHT IN THE COUNTY COURT.

Villarreal v. Harris County, No. 01-05-00993-CV (Tex. App.–Houston [1st Dist.] December 21, 2006, no pet. h.). (to be published).

Taxing unit sued taxpayer for delinquent taxes and obtained a judgment of foreclosure. Prior to foreclosure, the taxpayer obtained a tax lien loan and paid the judgment in full. Notwithstanding the payment, the taxing unit erroneously foreclosed the property and sold it, at a public sale, to a third party. (The taxing unit subsequently refunded the tax payment to the tax lien lender.) Taxpayer filed suit in district court alleging a wrongful taking of her property in violation of Article I, §17 of the Texas Constitution. The trial court dismissed the suit, holding that it did not have jurisdiction to hear the taxpayer’s claim. The appellate court agreed, finding that the taxpayer’s claim constituted a cause of action for inverse condemnation, and all condemnation claims are required to be filed in the county court.

NO GOVERNMENTAL IMMUNITY EXISTS WHEN A TAXING UNIT COLLECTS TAXES OUTSIDE ITS BOUNDARIES.

San Patricio County v. Nueces County, No. 13-05-022-CV (Tex. App. –Corpus Christi, December 7, 2006, pet. filed). (to be published).

San Patricio County (“San Patricio”) and Nueces County (“Nueces”) litigated a boundary dispute. San Patricio prevailed and subsequently sued Nueces to recover property taxes which Nueces had collected in the territory determined to belong to San Patricio. Nueces claimed it had governmental immunity from this suit. The appellate court disagreed. It held that Nueces could only claim immunity from prosecution for its activities within its own boundaries. Since the tax collections in question occurred outside the boundaries of Nueces, no immunity existed.

SECTION 42.09 PROHIBITS TAXPAYERS FROM COLLATERALLY ATTACKING FINALIZED PROPERTY TAX VALUATIONS.

Houston Independent School District v. 1615 Corp., No. 14-04-00859-CV (Tex. App.–Houston [14th Dist.] November 30, 2006, no pet.). (opinion on rehearing). (to be published).

Taxing unit filed suit to collect delinquent taxes for tax years 1984 through 1999. A judgment of foreclosure was obtained. The owner of the property at the time of judgment sold the property to a third party. That person paid $383,279.52 against the judgment and then quit making payments. The taxing unit, alleging an unpaid balance of $18,864.89 sought to foreclose its lien. The new purchaser obtained a temporary injunction blocking the sale and filed suit alleging either official mistake in the judgment or fraud on the part of the taxing unit because the tax judgment failed to recognize the homestead exemption which was applicable to the property in each of the years in controversy. The taxing unit sought dismissal of the suit on jurisdictional grounds, claiming that

the parties had failed to exhaust administrative remedies on the homestead question, that the tax payments rendered the lawsuit moot, and that the parties did not have standing to bring the action. The appellate court, on rehearing, agreed and held that Section 42.09 of the Texas Tax Code provides exclusive remedies for altering tax valuations including those for "recoupment of alleged overpayments of property taxes...not part of the procedures prescribed in the Property Tax Code."

A CERTIFIED AND SEALED COPY OF A DELINQUENT TAX RECORD OFFERED IN EVIDENCE AT A DELINQUENT TAX TRIAL IS NOT HEARSAY.

Reagans v. County of Dallas, No. 08-05-0043-CV (Tex. App. –El Paso, November 16, 2006, no pet. h.). (to be published).

At a delinquent tax trial, the taxing unit offered into evidence a document entitled "Property Tax Notice." The document was signed by the deputy tax assessor-collector, and was certified and sealed with the seal of the county. It reflected the identity of the taxpayer, the property being taxed and the amount of taxes, penalties, fees and costs owed. It purported to be a photocopy of a page from the original delinquent tax roll. The taxpayer objected on the grounds of hearsay. The appellate court found that the trial court did not abuse its discretion in admitting the document into evidence since the document conformed to the requirements of Section 33.47(a) of the Texas Tax Code.

CONTRACTUAL PROVISIONS RESTRICTING THE AMOUNT OF RENT WHICH MAY BE CHARGED TO LESSEES CONSTITUTE "INDIVIDUAL CHARACTERISTICS" OF A PROPERTY WHICH MUST BE CONSIDERED IN VALUING THE PROPERTY.

Western AH 406 Ltd. v. Central Appraisal District of Taylor County, 213 S.W.3d 544 (Tex. App. –Eastland 2007, pet. filed).

Taxpayer constructed an apartment complex under a contract with the United States Air Force. The agreement limited the amount of rent which could be charged to Air Force personnel and restricted the occupancy of the complex, giving priority to Air Force personnel. The appraisal district obtained a partial summary judgment blocking the use of the any rental data at trial that differed from market rental rates for comparable apartments in the area. As a result, judgment was entered for the appraisal district by the trial court. On appeal, the judgment was reversed. The appellate court ruled that the agreement between the Air Force and the taxpayer constituted an "individual characteristic" of the property which was required to be considered in the property's valuation pursuant to Section 23.01(b) of the Texas Tax Code. It further held that Rule 1-2(e) of the Uniform Standards of Professional Appraisal Practice mandated this result as well.

A DELINQUENT TAXPAYER MAY NOT DIRECT A TAX OFFICE TO APPLY A PARTIAL PAYMENT TO BASE TAX ONLY, AND NOT TO PENALTIES OR INTEREST.

Reinmiller v. County of Dallas, 212 S.W.3d 835 (Tex. App. –Eastland 2006, no pet. h.).

Taxing unit sued to recover delinquent taxes. Taxpayer defended on the grounds of incorrect calculation by the tax office. The taxpayer claimed that he had made payments to the tax office and placed restrictions on his checks instructing the tax office to credit the payments to "base tax only." He argued that the tax office's acceptance of those checks constituted an accord and satisfaction. The tax office testified that it had uniformly applied the payments to taxes, penalties and interest. The court rejected the taxpayer's argument and held that Section 31.073 of the Texas Tax Code prohibits taxpayers from directing the application of their payments.

TAX OFFICE IS UNDER NO OBLIGATION TO SEARCH FOR PARTIES CLAIMING TITLE BY ADVERSE POSSESSION; SERVICE BY PUBLICATION OF "UNKNOWN OWNERS" AND APPOINTMENT OF *AD LITEM* ATTORNEY PROTECTS THE RIGHTS OF ADVERSE POSSESSORS; TO CHALLENGE TAX SALE, ADVERSE POSSESSOR MUST FILE SUIT WITHIN ONE YEAR OF THE DATE THE TAX SALE DEED IS FILED AND THE PARTY MUST TENDER INTO THE REGISTRY OF THE COURT THE FULL DELINQUENCY AMOUNT.

Session v. Woods, 206 S.W.3d 772 (Tex. App. –Texarkana 2006, pet. filed).

Party claimed title to 2.25 acres by adverse possession and erected a structure and fence. Thereafter, the tax office foreclosed a larger parcel which included this acreage and sold it to another person at a tax sale. The new purchaser entered the property, tore down the fence and threatened to bull doze the structure. More than two years after the tax sale, the adverse possessor filed a trespass to try title suit seeking to have the court declare him to be the owner of the 2.25 acres. He claimed that the delinquent tax judgment did not affect him since he was not a named party to the suit. The court rejected his claim, finding no obligation on the part of the tax office to search for trespassers who might have "inchoate claims" to the property or to serve such claimants. It further held that the judgment of foreclosure was sufficient to reach such claimants because the tax office had sued "unknown owners" of the property by publication and an attorney ad *litem* had been appointed by the court to represent the interests of the unknown owners. Finally, the court held that the suit was untimely because Section 33.54(a)(1) of the Texas Tax Code requires challenges to tax foreclosure titles to be brought within one year of the date of recordation of the tax deed. The court further held that the adverse possessor had no right to contest the title because he failed to deposit into the registry of the court the full amount of delinquency as required by Section 34.08(a)(1) of the Texas Tax Code.

PROPERTIES SPECIFICALLY IDENTIFIED IN §4(B) OF THE DEVELOPMENT CORPORATION ACT OF 1979 ARE ELIGIBLE FOR EXEMPTION ALONG AS ARE OTHER PROPERTIES WHICH A BOARD OF DIRECTORS OF A DEVELOPMENT CORPORATION MAY DETERMINE TO BE ELIGIBLE; DETERMINATIONS OF ELIGIBILITY ARE SUBJECT TO JUDICIAL REVIEW FOR ABUSE OF DISCRETION AND CONSTITUTIONALITY; APPRAISAL DISTRICTS AND TAXING UNITS MAY CHALLENGE THE QUALIFICATION OF PROPERTIES FOR EXEMPTION.

Op. Tex. Att'y Gen. No. GA-0522 (2007).

Land and improvement projects specifically identified in §4(B) of the Development Corporation Act of 1979 are eligible for exemption. A board of directors of a development corporation may determine that other land and improvements which promote economic development are also eligible for exemption. These determinations are subject to judicial review for abuse of discretion. Courts may also review these

exemption determinations and rule whether those projects meet the Texas Constitution's public purpose use test. Appraisal districts and taxing units have standing to challenge tax exemption eligibility determinations under the Act.

A TAX INCREMENT FINANCING DISTRICT MAY NOT BE CREATED UNLESS "UNPRODUCTIVE, UNDERDEVELOPED OR BLIGHTED" PROPERTY IS INCLUDED IN THE ZONE.

Op. Tex. Att'y Gen. No. GA-0514 (2007).

A city may not designate an area as a reinvestment zone unless the area is "unproductive, underdeveloped, or blighted" within the meaning of Article VIII, section 1-g(b) of the Texas Constitution even if the area's plan for tax increment financing does not include the issuance of bonds or notes.

CANCELLATION OF RENDITION REQUIREMENT FOR BUSINESS VEHICLES DID NOT CREATE AN EXEMPTION FOR THEM.

Op. Tex. Att'y Gen. No. GA-0484 (2006).

The legislature added Section 22.01(k) to the Texas Tax Code. This section provides that owners of motor vehicles utilized for both business and personal purposes are not required to render them for taxation. This provision does not create an exemption for those vehicles from taxation. It merely eliminates the obligation to render them for taxation.

A CHDO OPERATING WITHIN A HOMESTEAD PRESERVATION DISTRICT IS ONLY ENTITLED TO EXEMPTION FROM CITY AND COUNTY TAXES FOR ITS PROPERTY LOCATED WITHIN THE DISTRICT; CITIES CREATING HOMESTEAD REINVESTMENT ZONES MAY NOT ESTABLISH TERMINATION DATES FOR THE ZONES; A COUNTY MAY NOT CONTRACT TO DEPOSIT ITS TAX INCREMENT FUNDS INTO A HOMESTEAD REINVESTMENT ZONE FOR A PERIOD OF GREATER THAN ONE YEAR AT A TIME; TAX INCREMENT FUNDS IN A ZONE MAY ONLY BE UTILIZED FOR HOUSING OR ZONE RELATED EXPENDITURES; HUD STANDARDS MAY BE UTILIZED IN CALCULATING INCOME ELIGIBILITY FOR PARTICIPATION IN A ZONE; THE INCOME QUALIFICATION STANDARDS ONLY APPLY IN THE INITIAL YEAR OF ELIGIBILITY FOR RESIDENCE IN A ZONE.

Op. Tex. Att'y Gen. No. GA-0474 (2006).

A Community Housing Development Organization operating within a Homestead Preservation District is entitled to exemption from city and county taxes for its property located within the district. (It is not entitled to exemption from school district property taxes.) Cities creating Homestead Reinvestment Zones may not establish termination dates for the zones. A county may not contract to deposit its tax increment funds into a Homestead Reinvestment Zone for a period of greater than one year at a time. Tax Increment Funds in a Homestead Reinvestment Zone may only be utilized for housing or zone related expenditures. U.S. Department of Housing and Urban Development standards may be utilized in calculating income eligibility for participation in a Homestead Reinvestment Zone. The income qualification standards only apply in the initial year of eligibility for residence in a zone.

ENDNOTES

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INTRODUCTION TO INTERNATIONAL TRANSFER PRICING

By Mark R. Martin and Cym H. Lowell[1]

I. Introduction

Transfer pricing has become an important international taxation issue for both tax administrations and taxpayers.[2] Transfer pricing issues arise with respect to the movement of goods, intangibles, services, or capital across international borders, where there is value or benefit on either side of the transaction. Generally, transfer pricing looks at whether the price charged for a transaction in goods, services, capital or intellectual property between affiliated enterprises (related parties) is "arm's length." Section 482 of the U.S. Internal Revenue Code provides that related party transactions must be priced at "arm's length,"[3] and this standard is applied by most countries.

The purpose of the arm's length standard is that related parties generally care about their global profit as a group and may not care where the profit is reported. Accordingly, such parties may be motivated to report more profit in a jurisdiction with a lower tax rate or where they could utilize a loss. Tax authorities apply the arm's length standard to prevent arbitrary shifting of income by requiring related party transactions to be priced as if they were between unrelated parties. Thus, tax authorities use the arm's length standard to prevent tax base erosion.

This article provides a general background of U.S. pricing law and highlights transfer pricing issues for taxpayers and government authorities.

A. Role of Transfer Pricing in International Taxation

The essential transfer pricing principles in all jurisdictions are generally similar under the umbrella of the OECD[4] Transfer Pricing Guidelines and Model Income Tax Convention. Deviations in a few jurisdictions are eliminated through treaty-based, Competent Authority negotiation procedures, or other means of pressuring such countries to conform to international standards.

If the taxpayer is doing business in two or more treaty countries, it has assumed taxpaying obligations in each jurisdiction. Transfer pricing is a three-way contest pitting tax administration against tax administration, in the case of bilateral treaty-country matters, with the taxpayer often occupying the position of *stakeholder* in the middle. Transfer pricing allocates income between jurisdictions. In this three-way contest, each party has its own concerns.

Each country touched by the operations of a multinational enterprise will want to tax an appropriate portion of the profits earned by operations within its borders. Thus, tax administrations of most developed and developing countries use transfer pricing as a tax base defense mechanism. On the other hand, multinational enterprises are concerned with defending their transfer pricing policies, often designed to facilitate the tax planning paradigm of the enterprise. From the standpoint most multinational enterprises, taxes are simply a cost of doing business which, like all costs, must be minimized to prevent a competitor from obtaining a competitive advantage from a lower tax rate.

II. Section 482

The purpose of Section 482 is to ensure that taxpayers clearly reflect income attributable to intra-party, or controlled, transactions and to prevent tax avoidance for such transactions.[5] In determining the true taxable income of a controlled taxpayer, the standard is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer, meaning that the transaction would be the same as one between uncontrolled taxpayers under the same circumstances. Because identical transactions are rare, comparable transactions under comparable circumstances are considered.[6]

A. Transfer Pricing Methodology

The regulations for Section 482 prescribe specified methodologies for determining the arm's length terms for the transfer of tangible property, intangible property, services and capital between controlled taxpayers.[7] In addition, the regulations allow the use of unspecified pricing methodologies where the specified methodologies do not apply.[8] The arm's length result of a controlled transaction must be determined under the method that provides the most reliable measure of an arm's length result.[9] While there are no priority rules for determining the best method, the regulations indicate under which circumstances particular methods are likely to be most reliable.

1. Tangible Property

With regard to transfers of tangible property, there are five specified methods: (1) the comparable uncontrolled price method; (2) the resale price method; (3) the cost plus method; (4) the comparable profits method; and (5) the profit split method.[10]

a. Comparable Uncontrolled Price Method

The comparable uncontrolled price ("CUP") method evaluates whether the amount charged in a controlled transaction is arm's length by reference to the amount charged in a comparable uncontrolled transaction.[11] Under this method, the taxpayer must establish that the products, contractual terms, and economic conditions associated with the controlled transaction bear a close similarity to those of the uncontrolled transaction.[12]

b. Resale Price Method

The resale price method measures an arm's length price by subtracting the appropriate gross profit from the applicable resale price for property involved in the controlled transaction.[13] The appropriate gross profit is computed by multiplying the applicable resale price by the gross profit margin earned in comparable uncontrolled transactions.[14]

c. Cost Plus Method

The cost plus method is ordinarily used in situations involving the manufacture, assembly, or other production of goods sold to related parties.[15] This method adds the

appropriate gross profit to the controlled taxpayer's costs of production in the controlled transaction.[16] The appropriate gross profit is computed by multiplying the controlled taxpayer's cost of producing the property by the gross profit markup, expressed as a percentage of cost, earned in comparable uncontrolled transactions.[17]

d. Comparable Profits Method

The comparable profits method ("CPM") evaluates whether a transfer price is arm's length based on objective measures of profitability (profit level indicators) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances.[18] The arm's length result is determined by the amount of profit that the tested party would have earned on related party transactions if its profit level indicator were equal to that of an uncontrolled comparable.[19]

The profit level indicators are ratios that measure relationships between profits and costs or resources employed.[20] The Treasury Regulations specify a number of profit level indicators that can be used in applying the CPM method. Whether the use of a particular profit level indicator is appropriate will depend on the facts and circumstances of the case, including the nature of the activities of the tested party, the reliability of the available data with respect to uncontrolled comparables and the extent to which the profit level indicator is likely to produce a reliable measure of the income that the tested party would have earned had it dealt with the controlled taxpayer at arm's length.[21] Once an appropriate profit level indicator is selected, the taxpayer should assemble profit level indicator data for the taxable year at issue and the preceding two years.[22] The Treasury Regulations describe the following profit level indicators:

Profit Level Indicator	**Definition**
Return on Capital Employed	Operating profit divided by operating assets[23]
Operating Margin	Operating profit divided by sales.[24]
Berry Ratio[25]	Gross profit divided by operating expenses.[26]

In addition, the Treasury Regulations provide that "other profit level indicators" not described in the Regulations may be used if they provide reliable measures of the income that the tested party would have earned had it dealt with the controlled taxpayers at arm's length.[27]

e. Profit Split Method

The profit split method evaluates the allocation of operating profit or loss in a controlled transaction to determine whether the allocation reflects the relative value of each controlled party's contribution to the combined operating profit or loss.[58] The profit allocated to any particular member of a controlled group is not necessarily limited to the total operating profit of the group from the relevant business activity; accordingly, in a given year, one member of the group may earn a profit while another member of the group incurs a loss.[29]

Profit split methods are used most often when both sides of the controlled transactions own valuable "nonroutine intangibles," meaning intangibles for which there are no reliable comparables.[30] If all valuable nonroutine intangibles were owned by only one side, the other side's contributions could be reliably benchmarked using the CPM.

The Treasury Regulations endorse two forms of profit split: (i) the "comparable" profit split and (ii) the "residual" profit split.[31] Under the comparable profit split, the controlled parties' total profits are split based on how parties in comparable uncontrolled arrangements would split profits.[32] Under the residual profit split, the controlled parties are each assigned a return for routine functions.[33] Any remaining system profit or loss is considered nonroutine intangibles and is split between the parties "based upon the relative value of their contributions of intangible property to the relevant business activity that was not accounted for as a routine contribution."[34]

2. Intangible Property

a. Generally

There are three specified methods for determining an arm's length amount charged in a controlled transfer of intangible property: (i) the comparable uncontrolled transaction method; (ii) the CPM discussed above; and (iii) the profit split method discussed above.[35]

b. Comparable Uncontrolled Transaction Method

The comparable uncontrolled transaction ("CUT") method evaluates whether the amount charged for a controlled transfer of intangible property was arm's length as compared to a comparable uncontrolled transaction.[36] This method requires that the controlled and uncontrolled transactions involve either the same intangible property or comparable intangible property.[37] For the intangible property to be considered comparable, both intangibles must (i) be used in connection with similar products or processes within the same general industry or market, and (ii) have similar profit potential.[38] Determining whether intangibles have similar profit potential involves examining the net present value of the benefits to be realized from the intangibles.[39] Absent such net present value evidence, all of the facts and circumstances surrounding the transfer must be examined, including the terms of the transfer (*e.g.*, exclusive or non-exclusive) and the stage of development of the intangible.[40]

c. Cost Sharing Agreements

Another issue is the treatment of intangibles developed as a result of the joint efforts of two or more controlled parties. A cost-sharing arrangement is an agreement between two or more controlled parties to share the costs and risks of a research and development project for an agreed upon scope in exchange for a specified interest in the project's results.[41] Since the participants in the arrangement jointly own the developed technology, there typically is no royalty obligation for a participant's use of the technology. For example, affiliates in the U.S., France and Japan might jointly develop technology that each affiliate will exploit in its respective regional market. A cost-sharing agreement can avoid royalties for the jointly developed technology, since joint owners exploit the technology. A cost-sharing agreement, however, must be "qualified" as set out in Treasury Regulation § 1.482-7(b).[42] A key requirement is that participants share development costs in proportion to their shares of reasonably anticipated benefits from exploitation of the intangible.[43]

One of the interesting issues in the cost-sharing context has been how participants that contribute pre-existing

intangibles should be compensated by other participants for the "buy-in" to such intangibles. The Treasury Regulations provide that a controlled participant that makes intangible property available to a qualified cost-sharing arrangement will be treated as having transferred interests in such property to the other controlled participants, and such other controlled participants must make buy-in payments to the party that transfers the intangible property to the cost sharing arrangement.[44] Proposed cost sharing regulations issued in August of 2005 adopt the "investor model" for buy-in payments to cost sharing arrangements, which are referred to as "external contributions" under the proposed regulations. Very generally, the "investor model" provides that external contributions to cost sharing arrangements should encompass separate payments for current product generation and for developing future product generations.[45]

3. Loans or Advances

If one member of a group of controlled entities makes a loan or advance directly or indirectly to another member of such group, without interest, or at a rate which is not equal to an arm's length interest rate, the IRS may make appropriate allocations to reflect an arm's length rate of interest for the use of such loan or advance.[46]

4. Services

Historically, the Treasury Regulations under Section 482 did not set forth specific methods for determining the arm's length charge for related party service transactions.[47] However, in August 2006, the IRS and the Treasury Department published Final and Temporary Regulations (the "Temporary Regulations") that describe six methods to price related party service transactions.[48] Those methods are: (1) the comparable uncontrolled services price method, (2) the gross services margin method, (3) the cost of services plus method, (4) the services cost method, (5) the comparable profits method, and (6) the profit split method.[49] Related party service transactions and the Temporary Regulations are discussed in depth in an article published in the last issue of The Texas Tax Lawyer.[50]

B. Determination of the "Best Method"

The Treasury Regulations have no strict hierarchy of methods, and particular transaction types are not assigned to particular methods. Instead, the Treasury Regulations prescribe a more flexible, "best method" approach, considering the method that provides the most reliable measure of an arm's length result.[51] Usually, data based on results of unrelated party transactions provide the most objective basis for determining an arm's length price.[52] In such cases, reliability is a function of (i) the degree of comparability between the controlled transactions or taxpayers and the uncontrolled comparable transactions or parties, (ii) the quality of the data and assumptions in the analysis, and (iii) the sensitivity of the results to deficiencies in the data and assumptions.[53] Factors affecting comparability include the industry, the functions performed, the risks assumed, contractual terms, the relevant market and market level, and other considerations.[54] Moreover, if there is a material difference between the controlled and uncontrolled transactions, adjustments must be made if it is possible to determine the effect of such differences on prices or profits with sufficient accuracy to improve the results' reliability.[55] Thus, the best method arises from the most reliable combination of transfer pricing methodology, comparables, and adjustments.

C. Arm's Length Range

In some cases, a pricing method will produce a single result that is the most reliable measure of an arm's length result.[56] In other cases, a method may produce several results from which a range of reliable results may be derived (an "arm's length range"), and a taxpayer whose results fall within the arm's length range will not be subject to adjustment.[57]

An arm's length range usually is derived by considering a set of two or more uncontrolled transactions of similar comparability and reliability.[58] If these comparables are of high quality,[59] then the arm's length range includes the results of all of the comparables (from the least to the greatest).[60] However, if the comparables are of lesser quality, the reliability of the analysis must be increased by adjusting the range through application of valid statistical methods.[61] The analysis' reliability increases when statistical methods establish a range of results in which the limits of the range will be determined such that there is a 75 percent probability of a result falling above the lower end of the range and 75 percent probability of a result falling below the upper end of the range.[62] The "interquartile range" (*i.e.*, the range from the 25th to the 75th percentile) generally provides an acceptable measure of this range.[63]

If the results of a controlled transaction fall outside the arm's length range, the IRS may make allocations that adjust the controlled taxpayer's result to any point within the arm's length range.[64] If the interquartile range determines the arm's length range, such adjustment will ordinarily be the median (*i.e.*, the 50th percentile) of the results.[65]

III. Section 482 Penalty

One of the most important elements of the current transfer-pricing environment is the potentially draconian penalty in Sections 6662(e) and (h), which can impose a 20 to 40 percent penalty on related tax underpayments. A helpful exception to the transfer-pricing penalty is the "reasonable documentation exclusion," which, in effect, excludes transactions covered by "contemporaneous documentation" of transfer pricing policies and procedures.[66] The documentation requirement is met if the taxpayer "maintains sufficient documentation to establish that [it] reasonably concluded that, given the available data and the applicable pricing methods, the method (and its application of that method) provided that the most reliable measure of an arm's length result" under the best method rule and provides that documentation to the Internal Revenue Service within 30 days of a request.[67] Generally, such documentation must exist when the return is filed.[68]

IV. The Importance of Transfer Pricing to Tax Executives

A. Background

The world of international transfer pricing and taxation is in a state of rather amazing evolution in 2006. The tax authorities in a broad range of countries have become well attuned to tax base defense via aggressive transfer pricing examination and the assertion of proposed adjustments based on clever theories, including profit split methodologies used by other tax authorities on their home country-based multinational enterprises. The current environment includes the following elements:

1. Contemporaneous Transfer Pricing Documentation

As discussed above, an exception to the U.S. transfer pricing penalty is available to taxpayers who prepare

contemporaneous documentation of their transfer pricing arrangements and provide such documentation to the IRS. Similarly, over 50 countries now require contemporaneous transfer pricing documentation.[69] Thus, compliance with these documentation requirements has become a critical issue for tax executives of multinational enterprises.[70]

2. Sarbanes-Oxley Compliance

Even if multinational enterprises have contemporaneous transfer pricing documentation in place, such enterprises may have Sarbanes-Oxley compliance problems if internal controls are not in place to ensure that the documentation was followed.[71] Advanced pricing agreements with tax authorities (discussed below) may be used to show that the company has internal controls in place for transfer pricing.

3. Increased IRS Examination of Transfer Pricing

Until recently, the IRS did not rigorously examine transfer pricing arrangements of U.S. multinational enterprises. This has changed in recent years. The IRS Large and Mid-Size Business Division (LMSB) stated in January of 2003 that it was undertaking a review of existing practices to ensure that the U.S. tax base is not being depleted by inadequate application of the arm's-length standards of Section 482 (the "LMSB Initiative").[72] Transfer pricing is stated to be the top priority in the LMSB Initiative, undertaken to assess the handling of transfer pricing issues and controversies. In addition, there are continuing criticisms from the U.S. Congress concerning the IRS' failure to enforce U.S. tax base defense through transfer pricing examinations.[73] Moreover, the LMSB Initiative provides that a penalty cannot be waived without International Territory Manager concurrence.

B. Advance Pricing Agreements

1. Background

Since 1991, the IRS has offered taxpayers, through the Advance Pricing Agreement ("APA") program, the opportunity to reach an agreement, before filing a tax return, on the appropriate transfer pricing method ("TPM") for related party transactions.[74] The IRS APA Program has completed over 500 APAs and is the leading program of its kind. Many treaty partners have developed APA procedures modeled after the U.S. Program.

The APA Program was borne out of the desire to resolve transfer pricing issues fairly and efficiently. There is a fundamental perception that fairness cannot be obtained in having the IRS' examination team – which is responsible for making audit adjustments - in charge of a voluntary dispute resolution process. Placing the APA Program in the Office of Associate Chief Counsel (International) gave the Program both the appearance of independence and actual independence from the examination function of LMSB. Over the years, the APA Program has succeeded and gained credibility with taxpayers as an honest broker in reaching agreement on difficult transfer pricing issues. The APA Program has jurisdiction to resolve transfer pricing issues under Section 482, the income tax regulations under Section 482, and relevant income tax treaties to which the United States is a party.[75]

2. Nature of APAs

An APA resolves transfer pricing issues on a prospective basis and is a collaborative process between taxpayers and the IRS to resolve these issues under the arm's length standard. A "bilateral" APA is an agreement between the IRS and a taxpayer on specified related party transactions coupled with an agreement between the United States and a treaty partner that the TPMs on such transactions are correct.[76] Although the IRS encourages taxpayer to seek bilateral APAs, it may execute an APA with a taxpayer without reaching agreement with a foreign tax authority (*i.e.*, a "unilateral" APA). A unilateral APA binds the taxpayer and the IRS, but does not prevent foreign tax administrations from taking different positions on the appropriate TPM for a transaction.

Because an APA resolves issues prospectively, the filing an APA request does not suspend any examination or other enforcement proceedings. However, in appropriate cases, a TPM agreed to in an APA may be applied to tax years prior to those covered by the APA ("rollback"). In this context, IRS Examination has jurisdiction to determine whether the rollback will be applied.[77] Similarly, if a rollback is requested in connection with a bilateral APA, the rollback will be handled in the Competent Authority process.

3. The APA Process

To begin the APA process, a taxpayer must submit an application for an APA, together with a user fee.[78] However, the taxpayer can anonymously solicit the informal views of the APA program. Taxpayers must file the appropriate user fee on or before the due date of the tax return for the first taxable year that the taxpayer proposes to be covered by the APA. Many taxpayers file a user fee first and then follow up with a full application later. The IRS team considering the APA request generally will include a team leader, an economist, an international examiner, LMSB field counsel and, in a bilateral case, a U.S. Competent Authority Analyst who leads discussions with the treaty partner.

4. APAs and Sarbanes-Oxley

As noted above, the Sarbanes-Oxley Act requires procedures to identify material transfer pricing exposures.[79] An APA is an agreement with one or more tax authorities, so exposure on the transactions covered appears to be minimal. Moreover, annual reports must be filed with the IRS (and typically other tax authorities in a bi-lateral APA) to establish that the APA has been applied by the taxpayer. This annual reporting requirement establishes a procedure (*i.e.*, filing of an annual report) that should be helpful in establishing that controls are in place to monitor transfer pricing arrangements.

V. Conclusion

Transfer pricing involves all transfers of value between affiliated entities (whether in connection with the transfer of tangible or intangible property, the rendition of services or the transfer of capital). Since every country touched by the extended operations of a multinational enterprise will want to ensure that such enterprise is paying an appropriate amount of tax in their country, tax executives for multinational enterprises must be vigilant in determining that such related party transfers of value are priced on an arm's length basis.

ENDNOTES

1 Mark R. Martin is a partner in the Houston office of Gardere Wynne Sewell LLP. Cym H. Lowell is a partner in the Dallas office of Gardere Wynne Sewell LLP.

2 *See* O'Haver, "Transfer Pricing: A Critical Issue for Multinational Corporations," Tax Analysts Doc. No. 2006-5915 (May 4, 2006).

3 IRC. § 482. Unless otherwise indicated, Section references are to the Internal Revenue Code of 1986, as amended.
4 Organization for Economic Co-operation and Development. *See* http://www.oecd.org.
5 Treas. Reg. § 1.482-1(a).
6 Treas. Reg. § 1.482-1(b).
7 Treas. Reg. §§ 1.482-3 (tangible property), 1.482-4 (intangible property), 1.482-9T (services), and 1.482-2(a) (capital).
8 *E.g.*, Treas. Reg. § 1.482-3(e)(1).
9 Treas. Reg. § 1.482-1(b).
10 Treas. Reg. § 1.482-3(a).
11 Treas. Reg. § 1.482-3(b).
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27 *Id.*
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34 *Id.* For an example of the application of the profit split method, see Treasury Regulation § 1.482-6(c)(3)(iii).
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MEXICAN FIBRAS

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As of January 2004, the Mexican Congress passed certain rules awarding special tax benefits to trusts which are used as real estate investment vehicles, also known as "FIBRAS" *(Fideicomiso de Infraestructura y Bienes Raíces)*.

For tax year 2007, the Congress passed by certain amendments related to the tax treatment of FIBRAS. Contrary to the expectations, the regime was not substantially changed.

The purpose of this article is to offer the reader a general insight on the concept of Mexican FIBRAS, as well as on the benefits derived from their tax treatment. Likewise, we intend to provide enough elements to conclude on the authentic nature of the benefits presented by the FIBRAS' regime.

I. NATURE OF THE FIBRAS AND GENERAL RULES

FIBRAS are trusts (fideicomisos) incorporated pursuant to Mexican Law, with the following characteristics:

- *Main business purpose*

FIBRAS' main business purpose must be: (i) the construction or acquisition of properties which are destined for lease; or (ii) the acquisition of intangible rights that entitle their holders to collect rents in connection with the underlying properties; and (iii) financing the so mentioned activities with a guarantee constituted by the leased property (mortgage).

- *Investment of wealth*

At least 70% of FIBRAS wealth must be invested in the real estate, intangible properties or credits described in the *Main business purpose* Section, while the remaining 30% must be invested in stock issued by the Federal Government, duly registered with the National Stock and Brokers Registry (*Registro Nacional de Valores e Intermediarios*), or in stock issued by Entities Investing in Debt Securities (*Sociedades de Inversión en Instrumentos de Deuda*).

- *Fiduciary and Certificates*

The fiduciary must be an authorized credit institution resident in Mexico for tax purposes that issues certificates that represent an interest over the underlying real estate/portfolio of FIBRAS. Such certificates are also known as "CPIs" (*certificados de participación inmobiliaria*).

CPIs may be placed among public investors, or they may be acquired by a group of at least 10 investors which must not be related parties among each other and must not have rights over more than 20% of the underlying real estate/portfolio individually.

In order for a FIBRA to apply for the special tax treatment foreseen under Mexican tax law, and therefore, for the benefits of said particular regime, certain requirements must be complied with:

- *Alienation of real estate*

Properties which are acquired or built by FIBRAS must not be sold for a period of 4 (four) years after their acquisition or the completion of their construction. Properties sold before such 4 (four) year period shall not be eligible for the tax treatment described in Section II.

- *Distribution of profits*

The fiduciary must distribute at least once a year a minimum of 95% of the overall tax result derived from the real estate/portfolio of FIBRAS among the CPI holders. Such distribution must be accomplished upon March 15 of the next immediate tax year when the income was generated.

II. TAX TREATMENT AND BENEFITS OF FIBRAS

- *Income and Asset Tax on the overall tax result derived from the real estate/portfolio of FIBRAS*

Generally speaking, Income Tax of FIBRAS shall be determined in a very similar way to that of a Mexican corporation, that is, **(i)** an overall tax result must be calculated (in the case of FIBRAS, by the fiduciary) and divided among the number of CPIs to determine the corresponding tax to each CPI; and **(ii)** the fiduciary or financial brokers (regarding CPIs placed among public investors) must withhold the Income Tax related to the CPI holders by applying a 28% tax rate over the distributed amount, <u>unless the CPI holders are exempt from said tax in respect to such revenue</u>.

Yet, FIBRAS are released from the obligation to file advanced payments of Income Tax, as well as from the obligation to pay Asset Tax if no Income Tax is due for the tax year at all.

- *Income Tax on the distributed tax result of CPI holders / Income Tax on capital gains deriving from the alienation of CPIs*

Mexican tax residents (individuals or entities) and non-Mexican tax residents with permanent establishments in Mexico must accrue the distributed tax result and/or the accruable profit deriving from the alienation of CPIs, same that must be determined by subtracting the average cost of the alienated CPIs from the income received for the sale (<u>unless they are exempt</u>). The tax withheld by the fiduciary/financial broker may be used by the Mexican tax residents as a credit against the Income Tax to be paid in the tax year of the distribution. The tax withheld to non-Mexican tax residents would be considered as a definitive payment.

- *Taxable surplus*

If the tax result derived from FIBRAS is higher than the distributed amount to the CPI holders, the fiduciary must pay Income Tax for such surplus at a 28% tax rate during the next fifteen days after March 15. After paid, the referred tax may be used by the CPI holders as a credit against the Income Tax

to be paid for the income derived from such surplus which they will receive later.

- *Refund of capital*

If the amount distributed is higher than the amount of the tax result derived from FIBRAS, such difference would be considered as a refund of capital, and the cost of acquisition of the CPIs of those holders who receive the refund would be reduced.

- *Alienation of real estate before the four-year period*

If properties contributed to FIBRAS were sold before the period of 4 (four) years after their acquisition or the completion of their construction, the fiduciary shall pay, on behalf of the CPI holders subject to tax, Income Tax at a 28% tax rate during the fifteen days after the alienation occurs, without having to withhold any tax for the distribution of such income.

The tax paid may be used by the CPI holders to which the fiduciary distributes the profit deriving from the alienation as a credit against the Income Tax to be paid in the fiscal year of the distribution.

- *Alienation of CPIs*

When CPIs are sold, the accruable profit must be determined by subtracting the average cost of the alienated CPIs from the income received for the sale.

The average cost of the CPIs must be calculated and determined for future alienations under the same mechanic as that applicable when dealing with alienation of shares.

The new holder of the CPI must withhold a 10% of the gross income which shall be paid, unless the seller is a Mexican tax resident or an entity exempt for Income Tax purposes in connection with income derived from real estate/portfolio of FIBRAS.

- *Deferment of Income Tax*

a) When Mexican tax residents and non-Mexican tax residents with a permanent establishment in Mexico receive CPIs in exchange of contributions of real estate to FIBRAS, the income derived from such contributions must be determined as follows:

The payment of Income Tax may be deferred upon the date of the sale of the CPIs, that is, it will have to be paid within the following 15 days of the alienation, at a 28% rate duly updated from the month when the contribution was made until the month when the alienation of the CPIs occurred. Such payment would be considered as a provisional payment of the referred tax for Mexican tax residents, and as a definitive payment for non-Mexican tax residents.

However, the tax initially deferred would have to be paid when the fiduciary alienates the real estate of FIBRAS, and the trustee who contributed such property would have to pay the related tax during the fifteen days after such sale.

b) When trustees contribute real estate to the FIBRAS, and such property is leased immediately by said trustees, the Income Tax to be paid for the alienation may be deferred upon two moments: (i) the date of termination of the lease agreement (as long as the effectiveness of the agreement does no exceed a period of 10 years); or (ii) the date of the sale of the contributed real estate by the fiduciary.

In this scenario, the tax deemed to each sold CPI must be applied a 28% tax rate, and the amount must be updated from the month when the contribution occurred until the month of its alienation or until the month when the lease agreement terminates.

III. FIBRAS BENEFITS APPLICABLE TO MEXICAN ENTITIES

Mexican corporations or partnerships will enjoy certain tax benefits, which differ from the benefits FIBRAS receive, when they comply with those requirements established for FIBRAS which refer to (i) the main business purpose; (ii) the investment of wealth; and (iii) the alienation of real estate; as it has been explained in Section I (*General Rules of FIBRAS*).

The tax treatment applicable to Mexican entities which comply with the aforementioned requirements shall be the following:

- *Deferment of Income Tax for shareholders*

Shareholders who contribute real estate to the entity would be able to defer the payment of the tax until the first of the following events:

– That the shares of the entity are sold in the proportion they represent of the total shares received by the shareholder for the contribution of the real estate; or

– That the entity sells the contributed real estate in the proportion that the sold part represents of the same real estate.

The income accrued must be updated from the month it was obtained until the month it shall be accrued in the abovementioned terms.

- *Taxes determined by the entity*

The entities are released from the obligation to file advanced payments for Income and Asset Tax purposes. However, unlike the FIBRAS, Mexican entities which are treated like FIBRAS are not exempt from the obligation to pay Asset Tax.

When certain foreign retirement funds are shareholders of the entity, it would be forced to give those shareholders a tax credit, which may be used as a credit against the annual tax. Such amount shall be considered as a paid tax for purposes of CUFIN (*cuenta de utilidad fiscal neta*).

IV. CONCLUSIONS

As a consequence hereof, it may be concluded that the **benefits for FIBRAS** under this tax treatment are the following:

- The release of the obligation to file advance Income Tax payments;
- The release of the obligation to pay Asset Tax;
- The deferment of the payment of Income Tax for CPI holders under certain conditions;

- The exemption from the payment of Income Tax for certain foreign retirement funds who are CPI holders related to FIBRAS; and

- The exemption from the payment of Income Tax for Mexican individuals and non-Mexican residents for tax purposes as holders of CPI's placed in Qualified Market for the profits they receive.

On the other hand, **Mexican entities** which comply with similar requirements as those needed for FIBRAS may enjoy certain **benefits**, such as:

- The release of the obligation to file advanced Income and Asset Tax payments;

- The deferment of the payment of Income Tax on shareholders of the referred entities; and

- The exemption from the payment of Income Tax for certain foreign retirement funds, as well as the possibility to receive a net profit from the entity.

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