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CHAIR'S MESSAGE

Greetings:

As Chair, it is my special privilege to work with the talented tax lawyers who serve as Officers, and Council and Committee members, of the Section. Their collective vision for the direction of the Section this year is exciting, and while we are still engaged in planning for this year, I can share with you initiatives in four areas: continuing legal education, pro bono activities, governmental submissions and membership benefits.

First, quality continuing legal education programs continue to be a significant part of the Section's plan. This year's programs include the successful seminars from past years, as well as a number of new programs similar to the one-day seminar on the American Jobs Creation Act of 2004. These latter programs will be designed to provide insight on hot topics in the tax law with qualified speakers from the government, and members of the local and national bars. To check for all upcoming programs, log on to the Section Website at www.texastaxsection.org. The currently scheduled programs include: The Advanced Tax Law Course, which was held in Dallas on September 29th and 30th, with a video replay in Houston on October 27th and 28th; the Tax Controversy Course to be held in Houston on December 2, 2005; and the Texas Tax Institute to be held in San Antonio on June 8th and 9th. As a reminder, for those not able to attend the seminar on the 2004 Act, it is still available online through the Website.

Incidentally, you will find the Website new and improved, providing links to the most recent Texas Tax Lawyer and an increasing number of outlines from past programs, all in word searchable format. Additionally, the Website now provides links to registration sites for all of the Section's upcoming programs.

Second, the Section will provide a venue for pro bono activities. At this time, the focus is on increasing our members' participation in two programs: Volunteer Income Tax Assistance (VITA), which is designed to help low-income taxpayers claim the earned income tax credit (EITC), and the Texas Community Building with Attorney Resources (Texas C-BAR), which is designed to provide free legal representation for community-based nonprofit organizations. The VITA program is sponsored by the IRS and various community organizations. If you are interested in participating, the first step is to complete a self-study course and test, which will permit you to assist low-income individuals in applying for the EITC during the 2005 tax filing season. At the present time, an overwhelming number of low-income individuals who qualify for the credit are either unaware or uncertain of how to qualify for the EITC. Texas C-BAR matches transactional attorneys with community organizations in need of legal assistance with projects ranging from drafting entity formation documents to applications for tax-exempt status. To learn more about all of these programs, please contact Dan Micciche at dmicciche@akingump.com or call (214) 969-2797.

Third, the Section will submit comments to the Treasury Department and the IRS on proposed regulations. Submitting comments is an important new development this year, and it will provide us with a voice in the regulatory process similar to that enjoyed by the Tax Sections of the American Bar Association, New York Bar Association and Chicago Bar Association. While the comments generally will be prepared by the Section's committee with substantive responsibility for the applicable area of the tax law, oversight for all comments will be undertaken by the newly created Committee on Governmental Submissions (COGS). The Section is privileged to have the following senior statespersons serve on the COGS: Stanley Blend of San Antonio, Vester Hughes of Dallas, Emily Parker of Dallas and Steve Salch of Houston. These comments, as delivered to the Treasury Department and the IRS, will be posted on the Website and distributed to the Section via email.

Fourth, as of June 24th, the Section added a Solo Practitioner and Small Firm Committee, to address the needs of the solo and small firm practitioners. This is but one step in a larger initiative to determine how we can better serve the Section's membership. Bill Elliot, the immediate past Chair of the Board of Directors of the Texas State Bar, has agreed to direct this process. While certain parts of this initiative are still being planned, one critical part is your participation. Whether you are contacted by email, direct mail or phone, I urge you to participate. The outcome of this process will be immeasurably more successful if we have broad based participation from the membership.

As Chair, I am directed under the Section's Bylaws to appoint a nominating committee, the membership of which is to be listed in the first Texas Tax Lawyer published following the Annual Meeting. This year's Nominating Committee consists of the Chair (as an ex-officio member), and Robert Gibson, Willie Hornberger and Jack Taylor. Under the nominating procedures adopted at the Section's 2004 annual meeting, the Nominating Committee selects candidates for the offices of Secretary, Treasurer and Chair-Elect and three Council members for the following year. Section members are encouraged to recommend candidates to the Nominating Committee. Each candidate must submit a candidate questionnaire, a copy of which is included in this issue of the Texas Tax Lawyer. Based on these candidate questionnaires and such other information as necessary, the Nominating Committee reports its nomination to the Council. Thereafter, the Council, at its last meeting preceding the Annual Meeting, elects the new officers and the Section members attending the Annual Meeting elect three new Council members from among those nominated by the Nominating Committee. I encourage you to submit nominations and candidate questionnaires to me at bbowers@fulbright.com.

Finally, on behalf of the Section, I would like to thank David Wheat, the immediate past Chair of the Section, for his leadership this past year. David, as the others who have served before him as Chair, provided an outstanding service to the Section. Many of the initiatives and programs discussed above were created or continued thanks to David's efforts. We wish him well in his practice and continued service to the Bar.

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

Name: ____

Firm Name: ____

Address: ____

City, State, Zip: ____

Email address: ____

Position: ____

Describe your involvement in the State Bar of Texas:

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Describe your involvement in other Bar activities:

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Describe other relevant experience for the position:

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SECTION OF TAXATION OF THE STATE BAR OF TEXAS

2005-2006 CALENDAR

July	
13	New Chair/Treasurer Orientation - Texas Law Center, Austin
15	Quarterly dues check mailed to Section Treasurer
24	Chair: Appoint Nominating Committee
29-30	SBOT Bar Leaders Conference - Omni Mandalay, Las Colinas
August	
1	SBOT Board Advisors: Reminder to committee/section chairs action requiring Board approval for September 23, 2005 Board meeting is due September 9, 2005
10	Texas Bar Foundation grant application deadline
12	Deadline for submitting articles for the October 2005 issue of the Texas Tax Lawyer
12	Chair: Submit names of Nominating Committee members for publication in Texas Tax Lawyer
31	Deadline for SBOT Dues, Texas Occupation Tax and Legal Services Fee
September	
1	Chair: Select Annual Meeting program chair and inform State Bar Annual Meeting coordinator
9	Deadline for receipt of data included in packets for September 23 SBOT Board of Directors meeting
16	Council of Chairs Meeting - Texas Law Center, Austin
15-17	ABA Section of Taxation Fall Meeting - San Francisco, CA
23	SBOT Board of Directors Meeting - Ambassador Hotel, Amarillo
29-30	23rd Annual Advanced Tax Law Course - Dallas
October	
2	Annual Meeting program chair: Select program and proposed speakers for SBOT Annual Meeting in 2006
14	10:30 a.m. - 12:30 p.m. Council/Committee Chairs Meeting **MANDATORY IN PERSON ATTENDANCE BY ALL COUNCIL MEMBERS AND EITHER CHAIR OR VICE CHAIR** Fulbright & Jaworski 2200 Ross Avenue, Suite 2800 Dallas, Texas 75201 (214) 855-8000

15	Quarterly dues check mailed to Section Treasurer
27-28	23rd Annual Advanced Tax Law Course (Video) - Houston
November	
18	10:30 A.M. - 12:30 P.M. Council Meeting Fulbright & Jaworski 2200 Ross Avenue, Suite 2800 Dallas, Texas 75201 (214) 855-8000
21	New Lawyer's Induction Ceremony - Frank Erwin Center, Austin
December	
9	Deadline for submitting articles for the February 2006 issue of the Texas Tax Lawyer
12	Chair: Prepare section mid-year report (due Jan. 6)
January	
6	Deadline for receipt of data for January 20 SBOT Board of Directors meeting
13	Council of Chairs Meeting - Texas Law Center, Austin
15	Quarterly dues check mailed to Section Treasurer
February	
2-4	ABA Section of Taxation Midyear Meeting - San Diego, CA
20	SBOT Board of Directors Meeting - Icon Hotel, Houston
27	10:30 a.m. - 12:30 p.m. Council/Committee Chairs Meeting **MANDATORY IN PERSON ATTENDANCE BY ALL COUNCIL MEMBERS AND EITHER CHAIR OR VICE CHAIR** Fulbright & Jaworski 2200 Ross Avenue, Suite 2800 Dallas, Texas 75201 (214) 855-8000
March	
1	Filing deadline for nominating petitions for SBOT and TYLA Director and President-elect positions
1	Deadline for receipt of nominations for Presidents' Award
3	Nominating Committee: Present nominations to the Council

3	10:30 A.M. - 12:00 P.M. Council Meeting Fulbright & Jaworski 2200 Ross Avenue, Suite 2800 Dallas, Texas 75201 (214) 855-8000
10	Nominating Committee: Publish nominations for Council members in the Texas Tax Lawyer
10	Deadline for submitting articles for the May 2006 issue of the Texas Tax Lawyer
27	Annual Meeting program chairs: Send information to State Bar for promotional Section flyers and Annual Meeting registration form
April	
1	Annual Meeting program chair: Annual Meeting hotel arrangements for guest speakers due
3	Deadline for SBOT Annual Meeting resolutions
7	Deadline for receipt of data to for April 21 Board of Directors meeting
14	Council of Chairs Meeting - Texas Law Center, Austin
15	Quarterly dues check mailed to Section Treasurer
15	Chair: Prepare section end-of-the year report for publication in July Bar Journal
21	SBOT Board of Directors Meeting - Sheraton Four Points Hotel, Brownsville
May	
1	Annual SBOT due statements mailed
4-6	ABA Section of Taxation May Meeting - Washington, D.C.
12	Council: Elect Chair-Elect, Secretary and Treasurer for 2006/2007 fiscal year
12	10:30 a.m. - 12:30 p.m. Council/Committee Chairs Meeting **MANDATORY IN PERSON ATTENDANCE BY ALL COUNCIL MEMBERS AND EITHER CHAIR OR VICE CHAIR** Fulbright & Jaworski 2200 Ross Avenue, Suite 2800 Dallas, Texas 75201 (214) 855-8000
22	New Lawyers' Induction Ceremony - Frank Erwin Center, Austin

June	
1	Due date for 2006 SBOT Dues, Texas Occupation Tax and Legal Services Fee
2	Deadline for receipt of data for June 14-15 SBOT Board of Directors meeting
8-9	Texas Tax Institute - San Antonio
9	Council of Chairs Meeting - Texas Law Center, Austin
14-15	SBOT Board of Directors Meeting - Austin
14-17	SBOT Annual Meeting, Austin

JOIN THE NEW PRO BONO COMMITTEE

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

Sound familiar?

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

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

We need your help.

Some of the projects that we will focus on include:

• Volunteer Income Tax Assistance (VITA)

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

• Texas Community Building with Attorney Resources (Texas C-BAR)

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

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

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

CORPORATE TAXATION: RECENT DEVELOPMENTS

Christina Markell-Balleza [1]

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

Corporation Deemed Owner of Stock of Subsidiary Despite Contribution of Subsidiary Stock to Voting Trust

Private Letter Ruling 200503013 (Jan. 21, 2005) held that a domestic corporation with a wholly owned domestic subsidiary was deemed to be the owner of all of the stock of its subsidiary for purposes of Section 1504(a) after the parent corporation contributed all of the stock of the subsidiary to an irrevocable voting trust. The parent corporation was partially owned by a foreign corporation that was primarily owned by a foreign governmental entity. Because of the nature of the subsidiary's business, a number of states, including the state where the subsidiary was incorporated, would not grant a license to a corporation engaged in such business if it is substantially controlled by a foreign government or an agency thereof.

To comply with the ownership requirements, the parent contributed all of its stock in the subsidiary to an irrevocable voting trust. The trust was established solely to comply with the state ownership statutes and was formed for a ten-year, renewable period, with early termination provisions enforceable with the consent of the relevant state if the trust is no longer necessary. All of the trustees of the trust were appointed by the parent and are restricted from transferring shares of the subsidiary except in the case of a merger, consolidation, or other business combination transaction involving the subsidiary. In addition, the government entity with equity interests in the parent made commitments to the relevant state not to participate or seek to influence the trustees, directors, or officers of the subsidiary. All distributions from the subsidiary during the time the stock was held in trust were payable to parent.

The parent and subsidiary desired to file returns on a consolidated basis. To be considered an affiliated group that is eligible to file returns on a consolidated basis, a parent corporation must own at least 80% of the vote and value of the subsidiary corporation. In prior guidance (Revenue Ruling 84-79), the IRS held that for purposes of Section 1504(a), a parent corporation was deemed to own the stock of a subsidiary corporation that it contributed to a revocable trust in order to comply with certain Federal Aviation Administration regulations. The parent corporation in that instance had the right to remove the trustee at any time and could dissolve the trust at will.

Although the case at hand involved an irrevocable trust in which the parent did not have any rights to control the trustees after the trust was created, the IRS found that the parent was considered to be the owner of the stock of the subsidiary for purposes of Section 1504(a). In reaching its conclusion, the IRS noted that the parent retains all economic interest in the subsidiary – it has a right to receive all distributions; it benefits from any appreciation in the subsidiary's stock; and through a sale of trust certificates, it can transfer all or a portion of its shares in the subsidiary, thus satisfying the 80% value test. The 80% vote test was deemed to be met even though parent relinquished its voting rights in the subsidiary. Because the trust was created solely to comply with state regulations and the parent appointed the initial trustees, the IRS held that the 80% vote test was met and contribution of the shares of the subsidiary did not create a disaffiliation event under the consolidated return rules.

IRS Finalizes Regulations Dealing with Stapled Foreign Corporations

On July 29, 2005, the IRS released final regulations under Sections 269B and 367(b) relating to stapled foreign corporations. T.D. 9216. The final regulations adopted regulations proposed in September 2004 in their entirety without modification. Among other items, the regulations provide the general rule that stapled foreign corporations will be treated as domestic corporations unless U.S. persons hold less than 50% of the vote and value of such corporation. The regulations also address (i) the ownership requirements for a corporation to be considered a stapled foreign corporation, (ii) the deemed conversion of a foreign stapled corporation if it reorganizes its place of incorporation to the United States, (iii) the deemed conversion of a United States corporation to a foreign stapled corporation, (iv) the interaction of the stapled foreign corporation rules with the consolidated return provisions, (v) the interaction of the stapled foreign corporation rules with international treaties, and (vi) various assessment and collection procedures relating to the stapled foreign corporation.

The IRS, in the preamble to the final regulations, noted that it received a comment to the proposed regulations regarding dual-listed corporations. Dual-listed corporations are two separate corporations that enter into equalization and voting agreements that generally result in the two corporations being operated under common control. Although there is no exchange of shares, because of the equalization and voting agreements, the shares of either of the companies usually reflect the combined economic attributes of both companies.

While the IRS is not aware of a dual-listed structure involving a foreign and domestic corporation, it has acknowledged that such a structure is possible. The IRS and Treasury Departments have requested further comments on the application of Section 269B to these types of dual-listed corporations and have announced plans to review these structures further.

Employee Recognizes Income from Exercise of Option During Period of Securities Laws Restrictions

Revenue Ruling 2005-48, 2005-32 I.R.B. 259, held that an employee who exercised a nonstatutory option to acquire stock during a period in which such employee was restricted from selling the stock pursuant to (i) rule 10b-5 under the Securities Exchange Act of 1934 (the 1934 Act) and (ii) an insider trading compliance program implemented by the subject corporation, must recognize the compensation income attributable to such option exercise at the time the option was exercised.

Section 83 generally requires a service provider to recognize as income the fair market value of any property received in excess of any amounts paid by such service provider for the property. The income will be recognized in the taxable year in which such property is either transferable or is no longer subject to a substantial risk of forfeiture. Treas. Reg. §1.83-3(j) provides that if the sale of property for a profit within six months of its acquisition would subject the seller to suit under section 16(b) of the 1934 Act, such person's rights in the property are deemed non transferable and subject to a substantial risk of forfeiture. As such, rights to property subject to section 16(b) are not includable in income until such restrictions lapse.

Although the service provider was similarly restricted from selling the stock he acquired pursuant to rule 10b-5 of the 1934 Act, the Section 83 guidance does not have a similar income recognition exception for stock subject to such prohibitions on transfer. In addition, because the restrictions imposed on the service provider's sale of the stock set forth by rule 10b-5 and the insider trading compliance program are lapse restrictions, such restrictions will not be taken into account in valuing the stocks for purposes of determining the amount of income the service provider must recognize.

The IRS and Treasury Department intend to amend Treas. Reg. §1.83-3(j) to include the holdings of Rev. Rul. 2005-48.

This Revenue Ruling fails to address the situation where a service provider continues to make purchases that are non-exempt under section 16(b) of the 1934 Act. Although the initial six-month period may have expired, by making periodic purchases, a taxpayer may extend the restrictions of section 16(b) of the 1934 Act. The Revenue Ruling does not address whether, if such extended restriction periods counted under the regulations, the taxpayer would be able to indefinitely defer income recognition.

ENDNOTES

1. Haynes and Boone, LLP, 901 Main Street, Suite 3100, Dallas, Texas 75202-3789, 214.651.5486 (phone), 214.200.0767 (fax), christina.markell-balleza@haynesboone.com.

RECENT DEVELOPMENTS APPLICABLE TO THE ENERGY AND NATURAL RESOURCES TAX AREA

Alyson Outenreath[1]

The following is a summary of selected current developments in the law relating to the energy and natural resources tax area. The summary focuses on federal tax law. It has been prepared by Alyson Outenreath, an associate at Thompson & Knight; Katrina Welch, Chair of the Energy and Natural Resources Tax Committee and Tax Counsel at Texas Instruments;[2] and Janet Jardin, Vice-Chair of the Energy and Natural Resources Tax Committee and an associate at Thompson & Knight LLP,[3] 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.

A. Energy Policy Act of 2005

President Bush signed into law The Energy Policy Act of 2005 (the Act) on August 8, 2005, just 10 days after the Senate voted 74-26 to approve the comprehensive energy bill.

President Bush stated that the Act lays the groundwork for a more energy-independent nation. The version of the bill ultimately agreed upon by the House and Senate resulted from negotiations within a conference committee. The conference committee largely followed the House version of the bill, H.R. 6.

The tax provisions of the Act focus on three principal areas: (1) improving energy-related infrastructure, (2) providing more incentives for traditional fossil energy production, and (3) breaks for conservation and energy efficiency improvements. The Act includes the following major provisions:

- Extending and modifying the tax credit for electricity generation from renewable sources, and providing that electric cooperatives can pass the credit through to their owners, which provides the biggest tax break at about $2.7 billion over 10 years.
- Expanding the scope of business energy credits against the alternative minimum tax, which will affect, among other items, the use of Section 29 carryforward credits for alternative minimum tax purposes.
- A tax credit for clean coal facilities, which is expected to cost about $1.6 billion over 10 years.
- A change in the rules relating to the decommissioning costs of nuclear power plants, which is expected to cost about $1.3 billion.
- Establishment of a seven-year recovery period for natural gas gathering lines, a 15-year period for natural gas distribution lines, and a 15-year recovery period for electricity transmission property, which will incentivize the production of fossil fuels.
- About $555 million in tax credits for solar power equipment for residential use to heat water, excluding pools and hot tubs.
- About $874 million in tax credits for buyers or leaseholders of fuel cell vehicles, alternative fuel vehicles, hybrids, and other advanced lean-burn technology vehicles. However, after the end of the first calendar quarter in which the manufacturer records its 60,000th hybrid vehicle sold, the credit is reduced to half and then a quarter of the original credit.
- The extension of the Leaking Underground Storage Tank Trust Fund financing rate and reinstatement of the Oil Spill Liability Trust Fund tax.
- Modification of the recapture of Section 197 amortization.

The Act as signed did not include a variety of provisions proposed by the House and the Senate. The conference committee rejected, among others, the Senate-proposed credit for clean coke/cogeneration manufacturing facilities and the House proposal to allow nonbusiness energy credits.

According to the Congressional Research Service, the enacted version of H.R. 6 provides approximately $14.5

billion in gross tax breaks. The Act provides revenue offsets of approximately $3 billion over 10 years, which was $2 billion less than the earlier Senate-approved version of the bill.

B. Coal Excise Tax MSSP Audit Techniques Guide Revised

The Internal Revenue Service (IRS) revised its Market Segment Specialization Program (MSSP) guide relating to the coal excise tax. The revised guide provides IRS examiners with tools and information on domestically-produced coal issues. With the revisions, the guide also has been brought up to date with 2005 law.

The revised guide addresses 13 specifically identified audit issues. It also provides general audit guidelines, sample information document requests, and a glossary of terms and background information relating to the mining and coal industry.

The 13 specifically identified audit issues include:

(1) Excess Moisture Reduction: Is it permissible to reduce the taxable weight of coal by excess moisture and what method should be used by taxpayers in calculating this reduction in taxable weight?

(2) Producer Versus Contract Miner: Who is liable for the coal tax when the miner does not possess an ownership interest under state law?

(3) Sales Price Inclusive of Federal Excise Tax (FET): How is FET determined when it is included in the sales price?

(4) Purchased Coal: How is a producer's tax liability for coal calculated when that producer also purchases coal from unrelated producers?

(5) Export Coal: Is the sale of domestically-produced coal that was in the stream of export when the Section 4121 tax would have been imposed considered a taxable or nontaxable sale?

(6) Transportation Costs in Sales Price: Should transportation costs be excluded in arriving at the taxable sales price of coal?

(7) Freeze-Dried Additive: Is the cost of adding a freeze-dried additive to coal allowed as a reduction in computing the taxable sales price of coal?

(8) Raw Versus Clean Tonnage: Should the tax imposed by Section 4121 be based on raw or clean tonnage sold?

(9) Mix of Underground and Surface Coal: If coal sold is a mixture of underground and surface coal, how is the tax liability under Section 4121 determined?

(10) Riverbed Dredging: Is coal extracted from a riverbed by dredging operations subject to the Section 4121 tax on coal?

(11) Refuse Pile Coal: Is a person who extracts coal from a coal refuse pile subject to the Section 4121 tax?

(12) Thermal-Dryer Coal: Is coal used by a producer in a thermal dryer to dry the producer's own coal subject to the Section 4121 tax?

(13) Claim for Refund: Can a producer of coal subject to the Section 4121 tax file a claim to recover an overpayment of FET?

C. IRS Publishes Revised Section 29 and Section 45 Factors

The IRS published in Notice 2005-33, 2005-17 I.R.B. 960, the inflation adjustment factor, the nonconventional source fuel credit, and the reference price for calendar year 2004, as required by Section 29 for purposes of determining the credit allowable on fuel produced from nonconventional sources. For calendar year 2004:

- The inflation adjustment factor is 2.1853.
- The nonconventional source fuel credit is $6.56 per barrel-of-oil equivalent of qualified fuels.
- The reference price is $36.75.

The IRS also published in Notice 2005-37, 2005-20 I.R.B. 1049, the inflation adjustment factor and reference prices used in determining the availability of Section 45 credits for renewable electricity production and refined coal production. The 2005 inflation adjustment factor and reference prices apply to calendar year 2005 sales of kilowatt-hours of electricity produced in the United States or a possession thereof from qualified energy resources and to calendar year 2005 sales of refined coal produced in the United States or a possession thereof. For calendar year 2005:

- The inflation adjustment factor is 1.2528.
- The reference price for calendar year 2005 for facilities producing electricity from wind is 4.85 cents per kilowatt hour. The reference prices for fuel used as feedstock within the meaning of Section 45(c)(7)(A) (relating to refined coal production) are $31.90 per ton for calendar year 2002 and $36.36 per ton for calendar year 2005. The reference prices for facilities producing electricity from closed-loop biomass, open-loop biomass, geothermal energy, solar energy, small irrigation power, and municipal solid waste have not yet been determined for calendar year 2005. Notice 2005-37 states that the IRS is exploring methods for determining the reference prices for calendar year 2006.

D. Publication Released on Fuel Tax Credits and Refunds

The IRS released Publication 378, Fuel Tax Credits and Refunds, in April 2005. The publication summarizes the fuel tax credits that taxpayers may claim on tax returns and refunds that can be claimed during the year. Specifically, the publication covers the following subjects:

- The kinds of fuels that qualify for a credit or refund.
- The uses of fuels that qualify for a credit or refund.
- Who may claim a credit or refund.
- How to claim a credit or refund for fuel taxes.

- The alcohol fuel mixture credit.
- The biodiesel mixture credit.
- The alcohol fuel credit.
- The biodiesel credit.

Publication 378 also highlights changes made by the American Jobs Creation Act of 2004 that affect fuel tax credits and refunds.

E. Low Salinity Water Injections Quality for Section 43 EOR Credit

The IRS concluded in PLR 200511002 (Mar. 18, 2005) that the injection of low salinity water qualifies as a tertiary recovery method for purposes of the Section 43 enhanced oil recovery credit. The facts of the ruling involved a certain field where there were several water producing wells that produced a low salinity water (*i.e.*, water containing fewer than a certain amount of parts per million total dissolved solids). The taxpayer intended to implement a project involving the injection of low salinity water into one of three reservoirs in the field as opposed to conventional high salinity water injection.

The taxpayer represented that the recovery method under consideration changes the properties of fluids in the reservoir by increasing the pH of the reservoir fluids by reducing the interfacial tension between the oil, reservoir rock, and water, and by increasing the water wettability of the reservoir. The proposed recovery method would also provide the energy and drive mechanism to force the oil to a production well.

The IRS noted in its analysis that the injection of low salinity water resembles waterflooding, which is not a method that qualifies under Section 43. However, the IRS concluded that the taxpayer's proposed method causes changes in the properties of the fluids in the reservoir that do not occur with conventional waterflooding. Based on these facts and other representations by the taxpayer, the IRS concluded that the recovery method to be implemented by the taxpayer was a qualified tertiary recovery method and, therefore, the project using the method would be a qualified tertiary recovery project provided that it met other requirements under Section 43 and the Treasury Regulations thereunder.

F. IRS Issues Revised Guidance on Certificate For Biodiesel

The IRS issued Notice 2005-62, 2005-35 I.R.B. 443, which modifies Notice 2005-4, 2005-2 I.R.B. 289, as modified by Notice 2005-24, 2005-12 I.R.B. 757. This new guidance relates to the certificate for biodiesel, which is a requirement for claiming a credit or payment under Sections 6426, 6427, and 40A. Notice 2005-62 revises the certificate to clarify that the claimant may obtain the certificate either directly from the producer of the biodiesel or indirectly from the biodiesel reseller. Notice 2005-62 also revised the prior rule set forth in Notice 2005-4 that each claim contain a statement that the claimant has in its possession an unexpired biodiesel certificate to instead require that the claimant generally must submit a copy of the certificate with its claim.

In addition, Notice 2005-62 provides guidance on accounting for commingled biodiesel and a transitional rule for claims made before August 29, 2005.

G. Federal Circuit Reverses Decision Relating to Tax on Enriched Uranium

In *PSI Energy, Inc. and Cincinnati Gas & Electric Co. v. United States*, 411 F.3d 1347 (Fed. Cir. June 10, 2005), the Federal Circuit reversed the Court of Federal Claims decision addressing the tax imposed by the Energy Policy Act (42 U.S.C.S. § 2297g-1(c)) on enriched uranium measured by the number of separative work units (SWUs) used. The lower court held PSI Energy and Cincinnati Gas & Electric Co. liable for tax levied on users of enriched uranium for production of nuclear power even though appellants did not use the enriched uranium or produce nuclear power. In reversing, the Federal Circuit held that the tax did not apply to utilities that sold their entire enriched uranium stock and did not actually use any enriched uranium.

The taxpayers argued that the statute at issue levied tax on the "user" of the fuel and that they should not be subject to tax because they did not use the fuel. The government claimed that the facts should be interpreted such that the taxpayers be deemed to have used a certain amount of fuel to enrich the uranium. The Federal Circuit held that, although the statute does not contemplate this rare situation, it was clear that the tax was intended to be levied only on the user of enriched uranium. The court held that, under any theory, the taxpayers did not use any of the enriched uranium. Rather, the taxpayers simply resold it.

H. Continued Guidance on Common Issues Concerning Section 29 Credits

The IRS issued additional guidance on common issues, including:

- Whether fuel constitutes a qualified fuel within the meaning of Section 29(c)(1)(C).
- Whether a contract constitutes a binding written contract in effect before January 1, 1997, within the meaning of Section 29(g)(1)(A).
- Whether production will be attributable solely to a certain taxpayer within the meaning of Section 29(a)(2)(B) such that the taxpayer will be entitled to Section 29 credits for qualified fuel produced by a facility and sold to unrelated persons.
- Whether the Section 29 credit may be allocated through indirect ownership under the principles of Section 702(a)(7).
- Whether a termination of a partnership under Section 708(b)(1)(B) will preclude the reconstituted partnership from claiming the Section 29 credit on the production and sale of synthetic fuel to unrelated persons.

In addition, these rulings provided that a facility was "placed in service" prior to July 1, 1998, within the meaning of Section 29(g)(1), and that relocation of the facility to a different location after June 30, 1998, or replacement of part of the facility after that date, would not result in a new placed in service date for the facility for purposes of Section 29, provided the fair market value of the original property is more than 20% of the facility's total fair market value at the time of relocation or replacement. Furthermore, these rulings provide that relocation of one or more of the independent production lines of the facility to a new location after June 30, 1998, will not result in a new placed in service date for the facility or an independent production line for purposes of Section 29, provided all essential components of the independent production line are retained and the production capacity of the independent production line is not significantly increased at its new location.

See PLR 200514003 (Apr. 8, 2005), PLR 200517016 (Apr. 29, 2005), PLR 200517017 (Apr. 29, 2005), PLR 200517018 (Apr. 29, 2005), PLR 200518053 (May 6, 2005), PLR 200518054 (May 6, 2005), PLR 200518055 (May 6, 2005), PLR 200518056 (May 6, 2005), PLR 200518069 (May 6, 2005), PLR 200527005 (July 8, 2005), PLR 200527006 (July 8, 2005).

ENDNOTES

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RECENT DEVELOPMENTS IN ESTATE AND INHERITANCE TAX

Jason Roy Flaherty [1]

The following is a summary of selected current developments in federal estate and gift tax law and the Texas inheritance tax. Unless otherwise indicated, all Section references are to the Internal Revenue Code of 1986, as amended.

A. CODE SECTION 2036

1. ***Strangi IV.***[2] On July 15, 2005, the 5th Circuit released its opinion affirming the Tax Court's decision that Section 2036 applied to assets transferred to a partnership by the decedent and therefore the assets should be included within the decedent's estate rather than the discounted value of the decedent's interest in the partnership.

   i) The court held that Section 2036(a)(1) applied because the decedent retained the possession or enjoyment of the assets. Though no express agreement existed that allowed him to continue to possess or enjoy the assets, the evidence indicated that there was an implied agreement. The evidence cited was the decedent's continued use of his personal residence that was contributed to the partnership, the partnership's payment of his personal expenses and the fact that the decedent had insufficient assets to meet his personal needs after the transfer.

   ii) Because it had already affirmed under Section 2036(a)(1), the court declined to address the Tax Court's holding that Section 2036(a)(2) also applied (i.e., that the assets were included within the estate because of the decedent's minority voting interest in the corporate general partner). This should at least make clear that the Section 2036(a)(2) holding in the Tax Court case was dicta.

   iii) The court then said that the transfer did not meet the exception to Section 2036 for a "bona fide sale for an adequate and full consideration." The court ruled that the second part of the test, that there was an exchange for an adequate and full consideration, was met because the decedent received a proportional interest in the partnership in exchange for the contributed assets. The court held, however, that the transfer was not "bona fide." Citing the test from the court's opinion in *Kimbell*,[3] the court ruled that the transfer did not have a "substantial business or other non-tax purpose."

   iv) The court ruled that the test is objective and the transferor's subjective intent is not relevant. The court then affirmed the Tax Court's factual findings under the clear error standard that there was not an objective non-tax purpose for the transfers to the partnership.

   v) The case more or less reaffirms the test from *Kimbell* (i.e., that the transfer to the partnership must serve a substantial non-tax purpose). The court in *Kimbell* had ruled that the decedent's estate had satisfied the "bona fide sale for an adequate and full consideration" exception where there was uncontested evidence of "substantial business and non-tax purposes" for the partnership. Post-*Kimbell*, it was unclear whether this test from *Kimbell* was conjunctive—that is, whether a partnership must have a business purpose as well as other non-tax purposes to qualify for the exception. Under *Strangi IV*, both a business and non-tax purpose is not required, although the court did not recognize this distinction when it used its slightly revised version of the exception from *Kimbell*.

   vi) Another important aspect of the opinion is the court's observation that, in *Kimbell*, the government did not challenge the estate's contention that the contributions to the partnership served substantial business and non-tax purposes. The court distanced itself from the position that the contribution of working oil & gas interests, like in *Kimbell*, is *per se* an active business enterprise, the transfer of which to a partnership will always serve non-tax purposes.

   vii) A potentially problematic part of the opinion is the court's reference to the decedent's inability to pay his post-death expenses (including estate taxes) after the contribution to the partnership. Although the court did not focus heavily on the estate taxes, this could represent an expansion of the amount of assets a taxpayer must maintain outside of the partnership to avoid a finding of an implied agreement among the partners that the taxpayer will retain the possession or enjoyment of the transferred assets.

B. GENERATION SKIPPING TRANSFER TAX

1. **Final Regulations on the Predeceased Parent Rule.** On July 18, 2005, the Treasury Department and the IRS issued final regulations relating to the predeceased parent rule. T.D. 9214.

   i) Section 2651(e) provides an exception to the general rule that a transfer to a grandchild of the transferor is subject to the generation skipping transfer (GST) tax. Prior to amendments made by the Taxpayer Relief Act of 1997, the predeceased parent exception under Section 2651(e) only applied to transfers from a grandparent to a grandchild when the grandchild's parent was deceased at the time of the transfer. The 1997 Act extended the exception to transferees who are lineal descendants of a parent of the transferor when the transferor has no living lineal descendants.

   ii) The final regulations provide that for purposes of determining whether the predeceased parent exception applies, a transferee's interest in property is established at the time the transferor is first subject to estate or gift tax on the transferred property. The final regulations did not adopt an exception in the proposed regulations relating to a remainder beneficiary's interest in a qualified terminable interest property (QTIP) trust.

   iii) The final regulations also did not adopt a provision of the proposed regulations that would have precluded the predeceased parent exception from applying to transfers to collateral heirs by a transferor who has no descendants but whose spouse does.

   iv) The final regulations also implemented rules for the generation assignment of adopted persons. An adopted transferee will be treated as a member of the generation that is one generation below the adoptive parent for purposes of determining whether transfers to the adopted transferee are subject to the GST tax if the following requirements are satisfied: a) the transferee is legally adopted by the adoptive parent, b) the transferee is a descendant of a parent of the adoptive parent (or the adoptive parent's spouse or former spouse), c) the transferee is under the age of 18 at the time of the adoption, and d) the adoption is not primarily for GST tax avoidance purposes.

2. **Final Regulations on GST Exemption Elections.** On June 28, 2005, the Treasury Department and the IRS issued final regulations relating to elections out of the automatic allocation of unused GST exemption to certain transfers to GST trusts. T.D. 9208.

   i) Under Section 2632, the available GST exemption, after making automatic allocations to direct skips, is automatically allocated to indirect skips to GST trusts unless the transferor elects otherwise.

   ii) The final regulations made several taxpayer friendly changes from the proposed regulations. In addition to allowing elections with respect to current transfers and future transfers to existing trusts to which there has been a current transfer, the final regulations allow elections with respect to certain designated future transfers to trusts and all future transfers by the transferor to any trust whether or not the trust is then in existence.

   iii) The final regulations also provide that an affirmative partial allocation of unused GST exemption for a direct skip is treated as an election out of the automatic allocation rules with respect to the value of the property not covered by the affirmative allocation.

C. STATE INHERITANCE TAX

1. **No Texas Inheritance Tax for Decedents with a Date of Death on or after Jan. 1, 2005.** With the phase-out of the state inheritance tax credit made by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), there is no longer a Texas inheritance tax. Under Texas Tax Section 211.051, the amount of the Texas inheritance tax is equal to the federal estate tax credit for state inheritance taxes. Under Section 2011(f), the state inheritance tax credit does not apply to estates of decedents dying after December 31, 2004.

D. MISCELLANEOUS

1. **Crummey Withdrawal Rights.** In *Watson v. Parker*, 325 B.R. 380 (Bank. S.D. Tex. 2005), the Bankruptcy Court held that when the trustee fails to give withdrawal notices to the beneficiaries as required under the trust agreement, contributions to the trust are subject to the claims of the beneficiary's creditors and the trust assets are not protected by the trust agreement's spendthrift provisions.

   i) In *Watson*, the settlor created three trusts for the benefit of the settlor's three grandchildren. The settlor had contributed about $340,000 to all three trusts over ten years which was intended to be partially free from gift tax by reason of the annual exclusion for gifts (other than future interests) under Section 2503(b) and the grant of lapsing withdrawal rights to the beneficiaries. One of the three grandchildren filed for bankruptcy when the value of his trust was approximately $190,000. Because the trustee never gave notice of the trust contributions, the court held that the contributions with respect to which the beneficiary had a right of withdrawal were part of the bankruptcy estate. However, the trust agreement limited a beneficiary's right of withdrawal in any one calendar year to the greater of $5,000 or 5% of the value of the trust's assets. Therefore, the trustee was only compelled to turn this amount over to the plaintiffs which, in this case, was substantially less than the ten year's worth of withdrawal rights.

   ii) The court reasoned that until the withdrawal notice is given (and it thereafter lapses), the trustee has no discretion to make distributions and it is contractually obligated to distribute the contributed property. The *Watson* case makes it clear that gift tax is not all that is at stake if the trustee does not give the required withdrawal notices.

2. **Investment Advisor Fees Paid by Trustee Subject to 2% of AGI Floor.** There is a circuit split on the issue of whether fees paid by a trustee to an investment advisor are subject to the 2% of AGI floor. In *Rudkin Testamentary Trust v. Comm'r*, 124 T.C. 304 (2005), the Tax Court ruled that the expenses were not deductible in a case that would have been appealable to the Second Circuit Court of Appeals, which had not yet ruled on the issue. The Tax Court ruled that the expenses are not deductible under the exception in Section 67(e)(1) for costs that are paid or incurred in connection with the administration of a trust that would not have been incurred if the property were not held in trust. The court ruled that investment fees are incurred by individuals as well as trusts and are therefore not "unique" to trusts or estates and therefore are not excepted from the 2% floor under Section 67(e)(1). Only the 6th Circuit has allowed the deduction, focusing on the trustee's fiduciary duties and how a trustee has a special need to hire an investment advisor. *O'Neill v. Comm'r*, 994 F.2d 302 (6th Cir. 1993). The Federal and Fourth Circuit courts have ruled that the 2% floor does apply. *Mellon Bank, N.A. v. United States*, 265 F.3d 1275 (Fed. Cir. 2001); *Scott v. United States*, 328 F.3d 132 (4th Cir. 2003). The Fifth Circuit has not ruled on this issue.

3. **Estate Tax Administrative Deduction for Interest.** In *Estate of Graegin v. Comm'r*, T.C. Memo. 1988-477, 56 T.C.M. (CCH) 387, the Tax Court held that the estate was allowed an administrative expense deduction under Section 2053(a)(2) for the entire amount of interest to be paid over the term of a note from a related corporation to fund the payment of the estate taxes. These notes have come to be known as "Graegin notes" and two recent IRS rulings reach different results on the deductibility of the interest.

   i) In TAM 200513028 (Apr. 1, 2005), the IRS ruled that the estate could not deduct the interest under a note from a partnership, 99% of the interests of which were owned by the estate. The IRS first noted that the loan was not a necessary expense because it was not necessary to preserve the value of an illiquid asset. The decedent had transferred 90% of his assets to the partnership, most of which were liquid investments. The IRS also noted that although the estate could not force a distribution of the partnership, the beneficiaries of the estate were the same persons that controlled distributions from the partnership. The IRS also noted that the interest was not deductible because it believed it was unlikely that the note would actually be paid and, under Section 2053, only reasonable and actual expenses are deductible.

   ii) In contrast, in PLR 200449031 (Dec. 3, 2004), the IRS allowed an administrative deduction for interest on a bank loan to pay the estate taxes. Unlike in TAM 200513028, the loan was from an unrelated bank. Further, the estate consisted of interests in a closely held corporation. The estate had sold much of the estate's illiquid assets to pay the taxes and the loan was for the balance.

4. **Valuation Discounts for Built-In Capital Gain.** By acquiescing in *Eisenberg v. Comm'r*, 155 F.3d 50 (2nd Cir. 1998), the IRS has conceded that there should be a deduction for built-in capital gain tax in valuing closely held stock. 1999-4 I.R.B. 4. In *Jelke v. Comm'r*, T.C. Memo. 2005-131, 89 T.C.M. (CCH) 1397, the Tax Court ruled that although a discount for the capital gains tax should be allowed, the amount of the discount should be based upon the present value of the tax taking into account when the tax is likely to be incurred. It is unclear, however, whether the court's decision would apply in the 5th Circuit in view of the 5th Circuit's opinion in *Dunn v. Comm'r*.[4]

   i) In *Jelke*, the decedent died owning a 6.44% interest in a closely held corporation. The corporation was incorporated in 1929 and its principal purpose had been holding and managing investments since the sale of the corporation's chemical business nearly thirty years prior to the decedent's death. The corporation's portfolio was invested by a professional trust company that was managed by a board of directors, none of whom were shareholders. At the time of the decedent's death there was no plan to liquidate a substantial portion of the corporation's assets.

   ii) The net asset value of the corporation's investments was approximately $188 million at the time of the decedent's death. Before applying discounts for lack of control and marketability in valuing the decedent's 6.44% stake in the corporation, the estate sought to first reduce the underlying net asset value by $51.6 million for the built-in capital gains on the assets.

   iii) The court allowed a deduction for the built-in capital gains tax. However, relying upon the testimony of the government's expert, the court only allowed a deduction for the present value of the tax discounted over a 16-year period with a discount rate of 13.4%. The court reasoned that although an asset-based (versus earnings-based) valuation method had been used, it was not reasonable to assume that there would be a complete liquidation of the corporation.

   iv) The court noted that the case was not appealable to the 5th Circuit. The 5th Circuit held in *Dunn v. Comm'r*, that when the asset-based valuation method is used, a dollar for dollar reduction for the built-in capital gains tax is allowed as a matter of law regardless of the hypothetical buyer's subjective intent to hold or sell the assets.[5] However, the court in *Jelke* said that the 5th Circuit's opinion in *Dunn* may have implied that a deduction for built-in capital gains tax is not appropriate when valuing a minority interest in a closely held corporation because such an interest may warrant the use of an earnings-based valuation method. Such a distinction, however, would seem inappropriate given that all shareholders (whether majority or minority) share a concern regarding the value of their investment. Further, a minority shareholder, unlike a controlling shareholder, has no control over liquidating events and the timing of the recognition of built-in capital gains. Therefore, an investor would seem to be even more likely to demand a dollar for dollar discount for built-in capital gains tax when the investment will be a minority interest.

ENDNOTES

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2. *Strangi v. Comm'r*, 417 F.3d 468 (5th Cir. Jul. 15, 2005).
3. 371 F.3d 257 (5th Cir. 2004).
4. 301 F.3d 339 (5th Cir. 2002).
5. *Id.* at 352-53.

TEXAS PROPERTY TAX LAW DEVELOPMENTS

John Brusniak, Jr.

UNITED STATES BANKRUPTCY COURTS

INTANGIBLE PERSONAL PROPERTY IS NOT SUBJECT TO A TAX LIEN.

In re: Southwest Broadband Holdings I, 326 B.R. 112 (Bankr. N.D. Tex., June 8, 2005).

Taxpayer filed for bankruptcy protection leaving no assets other than accounts receivable. Secured creditor filed an adversary proceeding against the taxing units contending that their delinquent tax liens did not extend to the accounts receivable and that the secured creditor was entitled to them. The taxing units countered that such assets were personal property and that under the Tax Code provisions pertaining to seizures, taxing units are specifically authorized to seize accounts receivable. The court disagreed, ruling that accounts receivable are intangible and are not taxable under the Tax Code, and as a result the tax lien did not extend to them. The court ruled that such receivables could have been reached in a tax warrant proceeding in state district court, but not otherwise.

TEXAS SUPREME COURT

UNDERGROUND STRUCTURES MAY BE TAXED SEPARATELY FROM THE LAND.

Matagorda County Appraisal District v. Coastal Liquids Partners, L.P., 165 S.W.3d 329 (Tex. May 27, 2005).

Underground salt dome caverns for storing liquid hydrocarbons were constructed and leased to taxpayer for an annual rent payment of $500,000. Taxpayer contended that the caverns were not separately assessable and could only be taxed as a part of the surface estate. The court disagreed, finding that some aspects of land, such as oil and gas leases, have always been separately assessed, and that had this improvement been constructed on the land's surface, rather than underground, its taxability would have been obvious. The court declined to specify a definitive test as to which aspects of land could be taxed, but stated that the individual characteristics of the property should be considered in making a determination as to whether the property should be separately assessed.

TEXAS COURTS OF APPEALS

PARTY MAY LEGALLY PURCHASE THE PROPERTY INTERESTS OF A TAXPAYER WHOSE PROPERTY IS ABOUT TO BE FORECLOSED AND BYPASS THE EXCESS PROCEEDS ASSIGNMENT PROVISIONS OF THE TAX CODE.

Woodside Assurance, Inc. v. N.K. Resources, Inc., No. 01-04-00006-CV (Tex. App.—Houston [1st Dist.] June 30, 2005, no pet. h.). (to be published).

Taxpayer, whose property was to be foreclosed pursuant to a delinquent tax judgment, sold his interest in the property to a third party. At the foreclosure sale, a company owned by the third party bid an excessive amount for the property to insure that it would obtain title to the property. Thereafter, the third party petitioned the court for release of the excess proceeds. A lienholder, whose interest had been foreclosed in the sale sought the release of the excess proceeds to it, arguing that the third party had illegally manipulated the foreclosure sale and had violated the provisions of the Tax Code pertaining to the assignment of excess proceeds. The court disagreed, ruling that no statutory provision exists prohibiting a person from purchasing a taxpayer's interest prior to a tax foreclosure sale and thereafter bidding on the property at the foreclosure sale. It further held that the excess proceeds provisions of the Tax Code only pertain to transfers which occur after a foreclosure sale, not before.

THE OWNER OF A LOW AND MODERATE INCOME HOUSING APARTMENT COMPLEX MUST BE A COMMUNITY HOUSING DEVELOPMENT ORGANIZATION FOR THE PROPERTY TO QUALIFY FOR EXEMPTION IF THE PROPERTY WAS CONSTRUCTED PRIOR TO DECEMBER 31, 2001.

American Housing Foundation v. Brazos County Appraisal District, 166 S.W.3d 885 (Tex. App.—Waco June 22, 2005, pet. filed).

A for-profit limited partnership with a nonprofit Community Housing Development Organization general partner, applied in tax year 2002 and 2003 for exemption from taxation for a low and moderate-income apartment complex that it owned. The appraisal district denied the exemption, and the court upheld the denial. The court ruled that properties constructed prior to December 31, 2001, by for-profit limited partnerships could not qualify for the exemption by having a qualified general partner. The statutory provisions pertaining to such properties required the owner of the property itself to be a Community Housing Development Organization. The for-profit entity owning the property was not such an organization.

TAXING UNIT MUST REFUND TAXES, PENALTIES AND INTEREST THAT IT COLLECTS IF A PROPERTY TAX VALUE IS LOWERED AS A RESULT OF AN APPEAL OF AN APPRAISAL REVIEW BOARD ORDER; ATTORNEY'S FEES MAY NOT BE RECOVERED IF SUIT IS FILED PRIOR TO 180 DAYS AFTER THE RIGHT TO REFUND ARISES.

Carrollton-Farmers Branch independent School District v. JPD, Inc., 168 S.W.3d 184 (Tex. App.—Dallas May 25, 2005, no pet.).

Taxpayer appealed to district court an appraisal review board order setting an appraised value at $2,992,780. While the case was pending, the taxing units filed a delinquent tax suit attempting to collect the taxes due under the appraisal review board order. They subsequently issued tax warrants, pursuant to which the taxpayer paid large sums of money to the taxing units. Thereafter, the district court in the appeal of the appraisal review board determination, lowered the value of the property to $186,300. The taxing units refunded to the taxpayer the base tax, but refused to refund the penalties and interest that they had collected, contending that the Tax Code specifically only referenced refunds of taxes and not of penalties and interest. Approximately 90 days after the appraisal district corrected its records, the taxpayer filed a counterclaim in the delinquent tax suit seeking the refund of the additional monies and seeking an award of attorney's fees from the taxing units. The court disagreed with the taxing units' construction of the statute, and ruled that penalties and interest cannot be determined until a base tax is determined in an appeal of an appraisal review board order. Therefore, no lawful penalties or interest had been collected by the taxing units. It ruled, however, that the taxpayer could not recover attorney's fees because the refund statute provides that attorney's fees are only recoverable if a suit for refund is filed 180 days after the date on which the claim for refund arises.

DECLARATORY JUDGMENT SUIT PERTAINING TO DELINQUENT TAXES MAY BE APPROPRIATE; ATTORNEY'S FEES ARE RECOVERABLE AGAINST TAXING ENTITIES IN DECLARATORY JUDGMENT ACTIONS.

Fort Bend County v. Martin-Simon, No. 01-04-00535-CV (Tex. App.—Houston [1st Dist.] May 12, 2005, no pet. h.). (to be published).

Taxing units sued a deceased taxpayer's estate and his unknown heirs for delinquent taxes for tax years 1977, 1978 and 1984 through 1991. On the same date, the taxing units sued one of the heirs for taxes due on her 25% share of the estate for tax years 1990 through 1997. (The taxpayer had previously deeded the property to his four children in equal shares in 1991.) The heir paid the taxes due in her suit. Three years later, the heir appeared in the original suit, filing an answer to the suit alleging that the taxes on her portion of the property had been paid in their entirety, seeking a declaratory judgment to that effect and attorney's fees. In response, the taxing units dismissed their case. After a post-judgment default trial on the counterclaim, the trial court entered judgment declaring that the taxes due on the heir's 25% interest were paid in full and awarding attorney's fees. The taxing units appealed, claiming that a declaratory judgment was inappropriate because the judgment merely clarified that the taxes had been paid in the prior suit and because the award of attorney's fees was impermissible due to governmental immunity. The court disagreed, finding that the declaration sought and obtained by the heir was appropriate because it was broader than the tax years encompassed in the prior suit, covering more tax years and identifying her interest in the property. It upheld the award of attorney's fees because such an award is appropriate when a taxpayer seeks a declaration as to the taxpayer's rights against the government under a tax statute.

A "CAPPED" RESIDENTIAL HOMESTEAD VALUE IS NOT NECESSARILY THE EQUIVALENT OF THE HOMESTEAD'S MARKET VALUE.

Dallas Central Appraisal District v. Cunningham, 161 S.W.3d 293 (Tex. App.—Dallas 2005, no pet.).

Taxpayer sued the appraisal district for tax year 2002 over the value of his residential homestead. An agreed judgment was entered setting the market value of the property at $200,000. The following year, 2003, the appraisal district sent the taxpayer a notice of appraised value setting the market value of his homestead at $374,330 and the appraised value at $225,000. On summary judgment, the taxpayer contended that he had performed $5,000 worth of improvements to his property, but that their market value was $0 and that the court should reduce the "market value" of his homestead to $220,000. The trial court granted summary judgment, and the appraisal district appealed. The court of appeals reversed, finding that the "market value" and "appraised value" of homestead property are not synonymous terms. The court held that the "market value" of a homestead is calculated under the general provisions of Chapter 23 of the Tax Code, while the "capped" or "appraised value" is calculated under the specific provisions of Section 23.23 of the Tax Code.

EVEN IF AN APPRAISAL DISTRICT MISLEADS A TAXPAYER AS TO THE NATURE OF AVAILABLE TAX CODE REMEDIES, SUCH ACTION WILL NOT CONFER JURISDICTION ON A DISTRICT COURT TO REVIEW A DISPUTE; FAILURE TO EXHAUST ADMINISTRATIVE REMEDIES BARS REVIEW OF A CLAIM BY A DISTRICT COURT.

Interstate Apartment Enterprises, L.C. v. Wichita Appraisal District, 164 S.W.3d 448 (Tex. App.—Fort Worth 2005, no pet.).

When the mortgage company informed a taxpayer that its property tax escrow was substantially short, the taxpayer called the appraisal district and complained that it had not received a notice of appraised value and asked what it could do to fix its excessive valuation. The appraisal district employee informed the taxpayer that its only remedy was to file a motion under Section 25.25(d) of the Tax Code to correct the valuation. The employee did not inform the taxpayer of its rights under Section 41.411 of the Tax Code. That section applies when an appraisal district fails to deliver a notice of appraised value. The taxpayer filed its motion to correct value under section 25.25(d) only to discover, after the appraisal review board ruled against it, that its property was not so excessively appraised as to qualify for relief under that statute, and by then it was too late to file a motion under Section 41.411. The taxpayer appealed the decision of the appraisal review board to the district court and contended that it should be allowed to pursue its remedies under Section 41.411 before the district court due to the incomplete and inaccurate information provided to it by the appraisal district. The court disagreed, ruling that a trial court cannot acquire jurisdiction by estoppel and that even if the appraisal district had intentionally mislead the taxpayer, such conduct could not confer jurisdiction upon the trial court. Accordingly, the court ruled that it could not review the claim under Section 41.411 because of the taxpayer's failure to exhaust its remedies before the appraisal review board.

A PERSON PURCHASING PROPERTY SUBJECT TO A TAX LIEN LOAN DOES NOT HAVE STANDING TO RAISE AN ISSUE AS TO USURY; A LENDER ON A TAX LIEN LOAN MAY RECOVER 10% OF THE LOANED AMOUNT IN ATTORNEY'S FEES IF THE TAXES WERE DELINQUENT AT THE TIME OF LIEN TRANSFER AND 15% IF THE TAXES WERE NOT DELINQUENT; INTEREST DUE ON A TAX LIEN LOAN DOES NOT TOLL WHEN MONIES ARE PAID INTO THE REGISTRY OF THE COURT.

Weisfeld v. Texas Land Finance Company II, 162 S.W.3d 379 (Tex. App.—Dallas 2005, reh'g overruled by 2005 Tex. App. LEXIS 4395).

Taxpayer obtained a tax lien loan on its property. Thereafter, a third party acquired title to the property subject to the tax lien loan. The lender sued the taxpayer and the third party to foreclose the tax lien. The third party tendered the amount that it believed was due and owing on the loan into the registry of the court while contending that the loan was usurious, that the lender could not recover attorney's fees and that the interest on the loan stopped accruing when the money was tendered into the registry of the court. The court disagreed, finding that claims of usury are personal to the person obtaining the loan and may not be asserted by subsequent parties in interest pursuant to the terms of the Finance Code, notwithstanding the provision in Section 32.065(e) of the Tax Code, which only provides that the penalties for usury shall be calculated under the terms of the Finance Code. The court further held that a party foreclosing a tax lien loan judicially is entitled to recover up to 10% of the lien amount in controversy if the taxes were delinquent at the time of the making of the loan and 15% of the loaned amount if the taxes were not delinquent at the time of the loan. Finally, the court held that a tender of the monies allegedly due into the registry of the court did not toll the running of interest on the loan since such a tender is not deemed to be made unconditionally.

A PURCHASER OF BUSINESS PERSONAL PROPERTY IS REQUIRED TO WITHHOLD AN AMOUNT SUFFICIENT TO PAY THE ENTIRE TAX AT THE TIME OF THE PURCHASE; IF THE PURCHASER FAILS TO DO SO, THE PURCHASER IS LIABLE UP TO THE EXTENT OF THE PURCHASER PRICE FOR THE TAX; A TAXPAYER WHO RECEIVES ACTUAL NOTICE OF AN INCREASED TAX VALUATION MAY NOT COMPLAIN THAT THE NOTICE WAS MISADDRESSED; IF A TAXPAYER FAILS TO TIMELY FILE A PROTEST UNDER SECTION 41.411 OF THE TAX CODE AND TIMELY TENDER THE TAXES DUE, THE TAXPAYER FORFEITS ITS STATUTORY REMEDIES.

Dan's Big & Tall Shop, Inc. v. County of Dallas, 160 S.W.3d 307 (Tex, App.—Dallas 2005, pet. denied).

Taxpayer purchased the assets of an ongoing business along with the right to continue doing business under the former owner's trade name. The purchaser properly filed an assumed name certificate showing its own correct name and address, but stating that it would continue doing business under the former trade name and at the former trade address. The taxpayer did not withhold the property taxes for the year of acquisition at the time of the sale, and apparently did not render the property for taxation in the following year. The appraisal district mailed the notice of appraised value in the name of the former owner to the former owner's address. Tax bills were sent in the same manner. The purchaser contended that it was only obligated to pay its pro rata share of the property taxes for the year of acquisition, citing the provision in Section 31.081 of the Tax Code, which provides that "a purchaser who fails to withhold the amount required...is liable...to the extent of the value of the purchaser price." The court held that the statute requires the purchaser to withhold the entire amount of property taxes due from the purchase price, and that the purchaser is liable for the entire amount unless that amount exceeds the total value of the property purchased. The court held that the delivery of the notice of appraised value and the tax bills to the business location and in the former owner's name were sufficient to give the new owner actual notice of the tax assessment and that the new owner should have taken other steps had it wished to receive notices in a different name and at a different location. Finally, the court held that the taxpayer could not avail itself of the remedies in Section 41.411 for the failure of the appraisal district to deliver the notice of appraised value to it because it had not timely filed its notice of protest with the appraisal review board and because it had not timely paid the taxes on the property, both of which constitute conditions precedent to the filing of such a motion.

TAX CODE REMEDIES ARE EXCLUSIVE AS TO BOTH TAXING UNITS AND TAXPAYERS; TAXING UNITS MAY NOT SUE TAXPAYERS DIRECTLY UNDER A FRAUD THEORY IN AN ATTEMPT TO RECOVER ALLEGEDLY UNDERPAID TAXES.

In re: Exxonmobil Corporation, 153 S.W.3d 605 (Tex. App. —Amarillo 2004).

Taxing units filed suit against oil and gas companies alleging fraud and conspiracy as to the manner in which oil and gas sale prices were reported to the Comptroller's office causing the property tax valuations for those companies' mineral interests to have been lower than they should have been and depriving the taxing units of property tax revenue which they would have otherwise received. The companies filed a plea to the jurisdiction alleging that the taxing units could not sue the companies directly, bypassing the provisions of the Tax Code. The taxing units responded that the Tax Code did not abrogate the common law rights that the taxing units possessed and that the Tax Code did not contain a provision limiting the rights and remedies of taxing units such as the provision in Section 42.09, which provides that Tax Code remedies are the exclusive means by which a taxpayer may challenge property tax issues. The court granted the plea to the jurisdiction, finding that the Tax Code was intended to be a comprehensive remedy for both taxpayers and taxing units. It held that the taxing units could utilize the tax challenge provisions, as well as the remedies contained in Chapter 43 of the Tax Code, to coerce the appraisal districts into pursuing the tax fraud claims as omitted property.

TEXAS ATTORNEY GENERAL OPINIONS

THE PROVISIONS MANDATING THAT PROPERTY VALUED BY MULTIPLE APPRAISAL DISTRICTS BE PLACED AT THE LOWEST DETERMINED VALUE ARE NOT UNCONSTITUTIONAL PER SE; CERTAIN PARTICULAR VALUATIONS UNDER THIS STATUTE MAY BE UNCONSTITUTIONAL.

Op. Tex. Att'y Gen. GA-0317 (2005).

Section 6.025(d) of the Tax Code, which requires the chief appraisers appraising property in overlapping jurisdictions to place the property at the lowest, ultimately determined appraised value, is not unconstitutional per se. It is possible that specific valuations may violate the constitutional requirement of taxation at market value, but these will need to be reviewed on a case-by-case basis.

NEW LEGISLATION

House Bills

House Bill 182 and Senate Bill 1351.

Effective: September 1, 2005.

A taxpayer may appeal an appraisal review board determination pertaining to the appraised value or market value of real property through binding arbitration if the Order Determining Protest sets a value of $1,000,000 or less for the property. Strict compliance with the statute is essential. (A party appealing through arbitration may not also file a lawsuit appealing the appraisal review board determination.) The appeal must be filed with the appraisal district along with a fee of $500.00 payable to the Comptroller within 45 days of the date of receipt of the Order Determining Protest. The Comptroller shall keep 10% of the fee to offset its costs. The Comptroller shall provide a list of arbitrators from which the parties may mutually select an arbitrator. If the parties fail to do so, the Comptroller shall select the arbitrator. The taxpayer may represent himself or herself at the hearing, or may use the services of an attorney, an appraiser, a real estate broker or salesperson, or a tax consultant. The appraisal district may be represented by an appraisal district employee. The arbitrator is required to rule on the appeal within 20 days of the date of the hearing. If the taxpayer substantially prevails, the Comptroller shall refund the portion of the arbitration fee not kept by the Comptroller, and the appraisal district shall pay that same amount to the Comptroller. If the taxpayer does not prevail, the Comptroller shall refund to the taxpayer any amounts remaining after the arbitrator and the Comptroller have been paid. Arbitration awards are enforceable under the Civil Practices and Remedies Code, but the arbitration results are not otherwise appealable. The taxpayer is required to pay the tax amount not in dispute to preserve the appeal. Failure to do so will result in the dismissal of the appeal.

House Bill 312.

Effective: September 1, 2005.

A property's designation as timber land does not change solely because its owner claims a portion of it as a residential homestead. Rollback sanctions are not imposed if a religious organization converts timber land to religious use within five years of ceasing to use it as timber land. Rollback sanctions do not occur if five acres or less of timber land are converted to non-profit cemetery use and the property is adjacent to a cemetery which has been in existence for more than 100 years.

House Bill 525.

Effective: September 1, 2005.

Cities with a population of more than 650,000 that are located in a uniform state service region with fewer than 550,000 occupied housing units may establish Homestead Preservation Districts, Homestead Land Trusts and Homeowner Land Banks to expand and promote affordable housing and to prevent the involuntary loss of homesteads by existing homeowners living in the district. Taxing units may transfer land into a homestead land trust without competitive bidding and may forgive taxes owing on property so transferred. Real property owned by a homestead land trust is exempt from taxation. The cities may create tax increment financing zones for this purpose as well. All taxing units within the zone shall pay their tax increment to the district. A Homeowner Land Bank may also be created. Tax foreclosed property may be sold by, and to, the land bank. Property sold to a land bank shall be exempt from taxation for up to three years.

House Bill 809.

Effective: January 1, 2006.
A person who operates one or more cars or trucks in connection with their occupation or profession (and who also uses the same vehicle or vehicles for personal activities) is not required to render those vehicles for taxation.

House Bill 1820.

Effective: June 18, 2005.

Cities no longer need to file copies of their annual TIF reports with the attorney general. Such reports are to be filed solely with the Comptroller.

House Bill 1984.

Effective: January 1, 2006.

Notices of appraised value shall state the percentage of increase or decrease in appraised value for a property from the current tax year to the fifth preceding tax year. Tax bills shall also be required to state the percentage of increase or decrease in appraised value for a property from the current tax year to the fifth preceding tax year and the tax differential for the same period. Through December 31, 2011, if this information is unavailable, the tax bill must state that this data is unavailable.

House Bill 2080.

Effective: June 17, 2005

A license to occupy a residential unit in an exempt elderly retirement community is not a taxable leasehold even if the resident is required to pay a deposit or a periodic service fee.

House Bill 2201.

Effective: June 18, 2005.

Property involved in either a clean coal project or a gasification project for a coal and biomass mixture is eligible for limited appraisal under the Texas Economic Development Act.

House Bill 2254.

Effective: September 1, 2005.

The interest rate for elderly and disabled persons making delinquent property tax installment payments on their residential homesteads is reduced from 12% to 6%.

House Bill 2382.

Effective: June 18, 2005.

The Board of Tax Professional Examiners shall create a training program for new chief appraisers. A new chief appraiser may serve up to one year without completing the training program, but no longer. This provision does not apply to a county tax assessor-collector who serves as chief appraiser.

House Bill 2438.

Effective: June 18, 2005.

If a person has elected to treat a manufactured home as real property, a tax lien attaches to both the home and the land on which it sits. A tax lien on a manufactured home may not be enforced unless the lien was recorded with the Texas Department of Housing and Community Affairs prior to October 1, 2005, or not later than six months after the end of the year for which the tax is owed. Other than manufactured homes held in inventory, titles to manufactured homes may not be transferred until all perfected liens have been cleared. Bona fide purchasers for value and lien holders on "Manufactured Home Statements of Ownership and Location" are not required to pay taxes that have not been recorded with the Texas Department of Housing and Community Affairs.

House Bill 2491.

Effective: September 1, 2005.

A request to an appraisal district that communications be directed to a taxpayer's fiduciary (other than a tax consultant) must be made in writing by the taxpayer and may only be revoked in writing by the taxpayer.

Residential homestead applications shall contain a place for applicants to list their birth dates. The elderly shall be automatically granted the additional exemption without the necessity of an additional application when the homeowner reaches the age of 65.

Rendition penalties and Section 25.25(d) penalties are to be added to tax bills and are secured by the tax lien on the property. The tax collector shall remit five percent of the rendition penalties to the chief appraiser.

The chief appraiser shall be required to consider the effect of a conservation easement on land that is included in a habitat preserve (or any other law that restricts the use of property to an endangered species) in determining the market value of the property.

The chief appraiser shall be required to distinguish between the currently specified categories of open space land use and shall further be required to divide each category into the currently specified categories of soil type and land use.

If a prorated tax tender is made after the acquisition of property by a governmental entity, the taxing unit is absolved from liability for making a refund in connection with the taxes that were due in the year of acquisition.

A taxing unit, which collects taxes for other units, may adopt tax discounts only on behalf of itself. It may charge an additional fee to the taxing units for which it collects taxes which do not adopt like discounts. A county tax assessor may terminate any collection contracts with taxing units which do not adopt like discounts.

A restriction or condition on a tax tender check that attempts to limit the payment of taxes, penalties or interest to an amount less than that shown on the collector's records is void.

A tax certificate shall reflect all additional allowable costs due to the government that are incidental to the collection of a delinquent tax.

A tax lien is superior to liens held by homeowner's associations and other similar entities. Homeowner's associations and similar entities are not necessary parties to a delinquent tax suit unless they have filed a sworn notice of lien with the county clerk. Such liens are foreclosed by the delinquent tax suit if the homeowner's association is made a party to the suit or if the lien was not of record at the time the suit was commenced.

A tax lien is superior to any right of remainder, right or possibility of reverter, or other future interest in the property whether it is vested or contingent. The tax lien has priority over these interests regardless of whether those interests existed prior to the creation of the lien.

A tax lien is inferior to a claim for a survivor's allowance, funeral expenses, or expenses of a last illness and to a validly recorded easement, provided that the easement was recorded prior to January 1 of the tax year in question.

A tax lien may only be transferred prior to the tax delinquency date if there are no other liens on the property; otherwise, only transfers of delinquent taxes are authorized. Once a lien has been transferred, subsequent tax year liens may be transferred without regard to whether the taxes are delinquent.

A tax lien loan may also include collection costs paid as shown on the receipt, expenses paid to record the lien, and reasonable closing costs.

The sworn lien transfer documents shall state the name and address of the transferee and a street address and legal description of the property.

The collector shall execute all lien transfer documents within 30 days. The collector may sign the documents before a notary public. All lien transfer documents may be combined into one form.

A transferred tax lien may be foreclosed nonjudicially if the contract so specifies.

The sworn statement and affidavit pertaining to a tax lien transfer must be filed in the county deed records to be enforceable.

Within six months of the date of transfer, a mortgage service provider is entitled to obtain a release of a transferred lien by paying the transferee the amount due under the contract. A transferee may charge a reasonable fee for a payoff statement after an initial payoff statement is provided.

After six months and before the initiation of foreclosure proceedings, a transferee may charge the property owner a reasonable amount to inform the property owner of the outstanding balance on the tax lien loan.

A mortgage service provider who pays off a tax lien loan becomes subrogated to all rights under the loan.

Unless otherwise specified in a contract, a tax lien loan may not be foreclosed until one year after the date the lien transfer is recorded.

A right of redemption exists on all foreclosed lien transfer properties. For all properties other than homesteads, agricultural land and minerals, the redemption period is 180 days. For homesteads, agricultural land and minerals, the period is two years. The redemption amount is 125% of the amount paid at foreclosure during the first year, and 150% of the amount paid at foreclosure in the second year.

A tax lien contract providing for nonjudicial foreclosure shall be recorded in each county in which the property is located. Foreclosure notices are to be served in the same fashion as deed of trust foreclosure notices. A copy of the foreclosure notice is required to be served simultaneously on the property owner and the mortgage service provider. A mortgage service provider may obtain a release of a tax lien by paying the amounts due under the contract.

Before accepting an application fee or executing a contract for tax lien transfer, the transferee shall inform the property owner of each type and amount of additional charges and fees which the owner may incur in connection with the loan.

A foreclosure affidavit executed by the transferee and recorded in the deed records reciting compliance with the tax lien foreclosure statute shall be prima facie proof of compliance with the statute and may be relied upon conclusively by a bona fide purchaser.

A religious organization acquiring property for its use is not entitled to a waiver of penalties or interest unless it makes its written request for waiver within a year of its acquisition of the property. Additionally, it must pay the taxes and obtain evidence of the approval of the exemption by the chief appraiser within the same period.

Requests for waivers of interest and penalties, based on existing statutory grounds, must be made within 181 days of the delinquency date.

A tax collector, who collects taxes on behalf of other taxing units, may enter into a tax payment contract with a taxpayer on behalf of those taxing units.

The government may recover its statutory attorney's fees in a tax warrant proceeding.

Tax bills threatening collection proceedings must inform the elderly and disabled of their right to abate payment of a delinquent tax on their homestead.

The government may assess its collection penalties on personal property anytime between February 1 and July 1.

After a tax warrant is issued, a tax seizure or sale may be canceled at any time by the applicant, the applicant's agent or the applicant's attorney.

A tax collector who accepts payments of court costs and other monies shall forward those monies to the appropriate parties.

Once a writ of possession is ordered by the court after a tax foreclosure, no further action by the court is necessary.

A sheriff or constable may use reasonable force in placing the purchaser of property at a tax foreclosure sale in possession of the property. A written notice shall be affixed to the front door of the premises, at least 10 days in advance, notifying the occupants of the impending eviction. The sheriff or constable may store property seized pursuant to a writ of possession at a bonded warehouse. A lien for the storage cost shall be placed on the property. The purchaser at a tax foreclosure sale shall not be responsible for the storage costs and may not be made to hold the property. A taxing unit is not required to post a bond to obtain a writ of possession.

Properties with tax delinquencies of ten or more years, and with total delinquencies exceeding the appraised value of the property, may be foreclosed on a streamlined basis. Suits may be filed by single or multiple taxing units, and may include multiple defendants with multiple properties. Petitions shall be served by certified mail (and by publication in a newspaper or other publication if a newspaper is not available) at least 45 days prior to the date set for hearing on the petition. The taxpayer may file a written response up to seven before the date set for the hearing. Taxing units are required to search for the identity and location of taxpayers by title search, by checking the tax records and appraisal districts records, and by looking in telephone directories, voter registration records and assumed name records. Under no circumstances may an attorney ad litem be appointed to represent the interests of a taxpayer in these suits. Before entry of judgment, an erroneously included parcel may be removed from the suit. A judgment may only be taken against the property and not against the person owning the property. Notice of the suit is valid, even if the prescribed methods for delivery of notice are not followed if: (a) the person has constructive notice of the suit by acquiring the parcel after the date of the filing of the petition; (b) the person has appeared at the hearing or filed a response or written communication with the clerk of the court before the hearing; or (c) the person has actual notice of the proceeding before the hearing.

If a taxpayer in a property tax lawsuit makes a written offer of settlement and a request for alternative dispute resolution within 120 days of the filing of the suit, deadlines for designating expert witnesses shall be the same for all parties. A property owner must designate a cause of action for either market value or equity as the basis of the request, but not both. Discovery on the alternate and any other grounds shall be conducted under the Texas Rules of Civil Procedure.

Monies paid into the registry of the court in a condemnation proceeding may not be withdrawn until proof is presented that the ad valorem taxes on the property have been paid.

House Bill 2653.

Effective: June 18, 2005.

A tax increment financing zone may be created to develop a bus rapid transit project or a rail transportation project.

House Bill 2926.

Effective: June 18, 2005.

If within six months of a foreclosure sale, the purchaser at the sale does not provide to the peace officer the requisite certificate showing that the purchaser is not delinquent in the payment of his or her property taxes, the peace officer shall deliver the return to the county tax assessor-collector. The return shall be filed with the county clerk and recorded in the name of the successful purchaser and all prior owners. The appraisal district may list the successful purchaser as the owner of the property in the appraisal records.

House Bill 3240.

Effective: January 1, 2006.

A beneficiary's residence, included in a court-ordered trust, qualifies for a homestead exemption.

Senate Bills

Senate Bill 18.

Effective: September 1, 2005.

If a taxing unit, other than a school district, wishes to increase the tax rate above the rollback tax rate, it must hold two public hearings prior to adopting the new tax rate. If a taxing unit, other than a school district, imposes $5,000,000 or more in taxes for maintenance and operations purposes, a tax rollback election may be called by obtaining the signatures of at least seven percent of the registered voters in the taxing unit. Real property tax bills must state for both the current year and for each of the preceding five years: (a) the appraised and taxable value of the property; (b) the tax rate for the taxing unit; (c) the amount of taxes imposed on the property; and (d) the difference between the numbers expressed as a percentage. Additionally, the same comparison shall be provided, in percentage terms, between the current year and the fifth preceding year. If any of this data is unavailable, the tax bill must state that the data is unavailable.

Senate Bill 541.

Effective: September 1, 2005.

Other than aerial photographs depicting five or more separately owned buildings, photographs, sketches and floor plans of residential real property may not be posted on the internet.

Senate Bill 567.

Effective: June 17, 2005.

In addition to the current “Truth in Taxation” publication requirements, taxing units shall publish in the newspaper the percentage difference in spending in the current proposed budget compared to the prior year budget, the total appraised value and taxable value in the current and the prior tax year and the total amount of outstanding bonded indebtedness for the taxing unit.

Senate Bill 580.

Effective: May 17, 2005.

Upon request by the recipient of a Purple Heart, Congressional Medal of Honor, Bronze Star, Silver Star, Legion of Merit, Service Cross, or a disabled veteran, a tax collector shall establish an escrow account into which the recipient may make tax payments.

Senate Bill 644.

Effective: May 17, 2005.

The existing provisions limiting eligibility of purchasers at a tax foreclosure sale do not apply in counties with a population of less than 250,000 unless the commissioners court of that county specifically adopts those provisions.

Senate Bill 692.

Effective: May 9, 2005.

A county tax assessor may not charge a river authority a greater fee for collecting its taxes than is specified in the statute authorizing the creation of that river authority.

Senate Bill 760.

Effective: January 1, 2006.

The chief appraiser shall be required to distinguish between the currently specified categories of open space land use and shall further be required to divide each category into the currently specified categories of soil type and land use.

Senate Bill 771.

Effective: June 18, 2005.

A tax increment financing zone may be created by a city with a population of 100,000 or more to redevelop an area in which less than ten percent of the structures (other than single family residences) have been used for commercial, industrial or residential purposes during the preceding twelve years.

In certain large cities, a property owner’s obligation to dedicate property or waive rights for property located in a Tax Increment Financing Zone is restricted to petitions which were filed prior to July 31, 2004.

A city creating a Tax Increment Financing Zone may determine the portion of the tax increment which is to be retained by the zone. If the city fails to specify a percentage, then the entire increment shall be retained. Certain large municipalities may reduce their existing contributions into tax increment zones provided that they allow the participating counties to do the same and provided that the reduction does not impair the ability of the zone to pay its obligations.

Senate Bill 828.

Effective: January 1, 2006.

Upon providing proper proof, a taxpayer may file a notice of protest up to the tax delinquency date if the taxpayer was working in the Gulf of Mexico (including on a drilling rig) for at least 20 consecutive days during which time the filing deadline passed or if the taxpayer was serving on full time duty in the United States military outside the United States on the date the filing deadline passed.

Senate Bill 898.

Effective: September 1, 2005.

A tax bill shall be mailed to both the taxpayer and the taxpayer’s agent. A tax lien is extinguished if a tax certificate erroneously shows that no outstanding taxes are due because of the erroneous omission of the property from the appraisal district’s appraisal roll.

Senate Bill 1205.

Effective: June 17, 2005.

With the approval of the voters, a multi-jurisdiction library district may be created by a city or a county, and it may impose an ad valorem tax to finance its operations.

Senate Bill 1587.

Effective: September 1, 2005.

The transferee of a tax lien must notify all recorded lienholders of an intended foreclosure on the property in the same manner as in a deed of trust foreclosure. All tax lien transfer contracts shall contain language to this effect.

Senate Bill 1652.

Effective: September 1, 2005, except for the farm and ranch machinery provision, which shall be effective January 1, 2006.

If a taxpayer mails something to the government on the due date, it is deemed timely filed or delivered.

The appraisal district board of directors shall biennially, at a public hearing, develop a written plan for the reappraisal of all real and personal property appraised by the appraisal district.

Machinery and equipment used for the production of farm or ranch products (regardless of its primary design) is exempt from taxation.

The Comptroller may prepare and issue publications relating to tax appraisal and may approve publications of other organizations such as the Appraisal Institute and International Association of Assessing Officers. The Comptroller may prepare cost, price and depreciation schedules, but the Comptroller's authority for preparing local market index factors and departure standards is removed.

A taxpayer whose property is subject to an agreement to limit its appraised value pursuant to the Texas Economic Development Act is not eligible to receive a sales tax or franchise tax refund under chapters 151 and 171 of the Tax Code.

The Comptroller shall prepare a report every two years of the number of state franchise and sales tax refund applications received as a result of the limited appraisal provisions contained in the Texas Economic Development Act.

A motor vehicle does not have a taxable situs in a taxing unit if it is located there for less than 60 days and is offered for resale by a person who holds a wholesale vehicle auction general distinguishing number from the Texas Department of Transportation. A person who holds a wholesale vehicle auction general distinguishing number from the Texas Department of Transportation is not required to report to the appraisal district vehicles which have not acquired a tax situs within the taxing unit, vehicles offered for sale which are otherwise subject to the motor vehicle inventory tax and vehicles which are in the process of being resold under foreclosure proceedings.

Notices of appraised value for residential property subject to a tax freeze because they are owned by disabled individuals shall state that the taxes on the property may not be increased.

TEXAS TAX LAW UPDATE: AN OVERVIEW OF RECENT ADMINISTRATIVE AND JUDICIAL DECISIONS

David E. Colmenero [1]

The following article provides an overview of the more significant recent administrative and judicial decisions in Texas tax law, focusing specifically on the Texas sales and use tax and franchise tax. The period covered is from March 15, 2005 to August 15, 2005. The Third Court of Appeals issued several opinions in cases that are discussed below, including cases addressing the constitutionality of the earned surplus throwback provision, the applicability of U.S. Public Law 86-272 to the taxable capital portion of the franchise tax, the extent to which an informal review of a refund claim tolls the statute of limitations for refund claims under pre-2003 law, and the extent to which a claim can be maintained under the Texas Uniform Declaratory Judgments Act where a protest letter is held invalid.

The Comptroller also issued rulings that are worth noting. These include rulings addressing the apportionment of embedded software, the statute of limitations on claims for refund, nexus and the applicability of U.S. Public Law 86-272 with respect to a distribution network company and a multi-level marketing company, and the availability of the manufacturing and resale exemptions to telephone and telecommunications service providers.

Readers should take particular note of the first case discussed below in which the Court of Appeals determined that the throwback provision was unconstitutional as applied to the taxpayer in that case.

Franchise Tax

Home Interiors & Gifts, Inc. v. Strayhorn, No. 03-04-00660-CV, 2005 WL 2313518 (Tex. App.—Austin September 22, 2005, no pet. h.): Earned Surplus Throwback Provision Violates The Commerce Clause and Creates Opportunity For Refund Claims.

In a case involving the refund of franchise taxes, the Third Court of Appeals in Austin held that the earned surplus throwback provision of the franchise tax is unconstitutional as applied to the taxpayer in that case. This case is significant, not only because it overrules the Legislature's throwback provision on constitutional grounds, but also because it creates the opportunity for refund claims for any similarly situated taxpayers. We understand that the Comptroller expects a substantial number of refund claims on the basis of this decision.

The taxpayer in this case is Home Interiors & Gifts, Inc. (Home Interiors), a Texas corporation engaged in the business of wholesaling home-décor products to independent contractors. Virtually all of its operations and employees are in Texas. However, the majority of the independent contractors to whom its products are sold are located out of state. As a general matter, Home Interiors appeared to be protected from income tax imposed by states other than Texas on the basis of U.S. Public Law 86-272.

Home Interiors sought a refund of its franchise tax, arguing that the prescribed statutory method for the apportionment of the earned surplus component of the franchise tax, specifically the "throwback provision," was unconstitutional. The Comptroller issued a ruling stating that it did not have the authority to rule on the constitutionality of a statute. The taxpayer then brought suit in district court, which upheld the constitutionality of the throwback provision. The taxpayer appealed.

The taxpayer argued that the earned surplus throwback provision unconstitutionally burdens interstate commerce. In examining this claim, the Court applied the test from *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), which set forth a four-part test for determining the constitutionality of a statute. In *Complete Auto*, the U.S. Supreme Court held that a tax is constitutional under the Commerce Clause when it is applied to an activity with a substantial nexus with the taxing state, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the state. Home Interiors argued that the throwback provision violates the fair apportionment requirement of the Commerce Clause.

The Court used an internal consistency test developed by the U.S. Supreme Court to determine whether the tax was fairly apportioned. This test requires the assumption of a hypothetical scenario, in which every state is presumed to impose a tax identical to the tax at issue. It then examines whether interstate commerce bears a larger burden than intrastate commerce. If it does, then the tax is neither internally consistent nor fairly apportioned. Home Interiors argued that the interplay between U.S. Public Law 86-272 and the Texas earned surplus throwback provision causes the franchise tax to be internally inconsistent as applied to it.

Applying this test, the Court determined that the throwback provision causes the franchise tax to be internally inconsistent. The Court determined that the Texas franchise tax would cause an intrastate corporation to be assessed on 100% of either its taxable capital or its net taxable earned surplus, but not both. An interstate corporation would also be liable to Texas for the greater of tax on the earned surplus or tax on the net taxable capital. However, while U.S. Public Law 86-272 would operate to protect an interstate corporation like Home Interiors from tax based on its net income in states other than Texas, the interstate corporation would be subject to franchise tax based on the taxable capital in those states that hypothetically apply the integrated Texas franchise tax. Thus, because an interstate corporation would be subject to tax that an intrastate corporation would never bear, the franchise tax is not internally consistent.

The Comptroller argued that the Texas franchise tax is internally consistent because, if every corporation were in fact imposed a tax identical to the Texas franchise tax, no more than 100% of an interstate corporation's taxable capital base or net-taxable earned surplus would be subject to tax. According to the Court, the Comptroller essentially argued that the internal consistency test should be applied to one tax base at a time (i.e., net taxable capital or net taxable earned surplus). The Court rejected this argument, relying on two Supreme Court decisions, *Armco, Inc. v. Hardesty*, 467 U.S. 638 (1984) and *Tyler Page Industries, Inc. v. Washington Department. of Revenue*, 483 U.S. 232 (1987). The Comptroller also argued that the tax was not facially discriminatory and would pass the internal consistency test if it were not for U.S. Public Law 86-272. The Court also rejected this argument holding that it would be improper to analyze the franchise tax without considering U.S. Public Law 86-272, given that the earned surplus throwback provision exists because of U.S. Public Law 86-272. [2]

Because the tax was not fairly apportioned, the Court held that it was unconstitutional in this case. However, the Court did note that the U.S. Supreme Court has envisioned a remedy that may be appropriate in Texas. Specifically, the Court stated that the Texas Legislature might consider granting an interstate company like Home Interiors a franchise tax credit to offset any taxes assessed on the interstate company's capital by a state that throws back receipts to Texas.

Home Interiors creates the opportunity of refund claims for many taxpayers. Taxpayers who have been subject to the throwback provision under the Texas Tax Code should consider filing a refund claim on the basis of the *Home Interiors* case. *Home Interiors* is not yet a final decision and will likely be appealed. However, the lack of finality on this issue should not keep taxpayers who are entitled to a refund from filing refund claims in order to avoid losing the refund claim due to the statute of limitations expiring.

Inova Diagnostics, Inc. v. Strayhorn, 166 S.W.3d 394 (Tex. App.—Austin May 26, 2005, pet. filed): U.S. Public Law 86-272 Does Not Prohibit The Imposition Of The Franchise Tax On Out-of-State Corporation Employing Only One Sales-Person in Texas.

Inova Diagnostics addresses the question of whether the State of Texas is precluded from assessing the taxable capital portion of the franchise tax against a taxpayer who is protected from income tax under U.S. Public Law 86-272. The taxpayer argued that the taxable capital and earned surplus portions of the franchise tax are part of a single tax and cannot be separated for purposes of applying U.S. Public Law 86-272. The Court held that the State may in fact impose tax on a taxpayer's taxable capital even where the taxpayer is not subject to the earned surplus portion of the franchise tax.

The taxpayer in this case is INOVA, a California corporation engaged in the business of developing and manufacturing products used in medical testing. It has only one employee in Texas who was hired in 1996. That employee's activities in Texas are limited to visiting existing and prospective customers, providing promotional materials and demonstrating INOVA products. Orders are placed directly with INOVA in California and are delivered via mail or common carrier.

The parties agreed that INOVA only engages in the solicitation of orders in Texas for purposes of U.S. Public Law 86-272. However, the Comptroller maintained that, while INOVA may be exempt from the earned surplus portion of the franchise tax, it is nevertheless subject to the taxable capital portion of the tax.

INOVA argued that it was entitled to a refund of franchise tax it had previously paid under protest. In support of its claim, it argued that (i) the Texas franchise tax is a single integrated tax and may not be separated into components for the purpose of avoiding the application of U.S. Public Law 86-272; (ii) even if the taxable capital component stands alone, U.S. Public Law 86-272 prohibits the imposition of that portion of the franchise tax against INOVA because the capital component is imposed on, or measured by, net income; and (iii) INOVA lacks substantial nexus with the state.

The Court disagreed with each of these arguments. As to the first argument, the Court determined, after examining the language in the Tax Code, that the Legislature in fact intended for the franchise tax to be imposed on net taxable capital when a corporation is exempt from paying tax on earned surplus under U.S. Public Law 86-272. It therefore held that the Comptroller's rule, which states that a corporation may be subject to the taxable capital component but not the taxable earned surplus in light of U.S. Public Law 86-272, is not inconsistent with the Tax Code.

As for INOVA's second argument, the Court noted that two other courts have rejected similar arguments, namely the

Michigan Court of Appeals in *Gillette Co. v. Department of Treasury*, 497 N.W.2d 595 (Mich. Ct. App. 1993) and a New Jersey Appellate Court in *Clairol, Inc. v. Kingsley*, 262 A.2d 213 (App. Div. 1970). The Court also determined that the legislative history of U.S. Public Law 86-272 recognizes its limited nature and supports the conclusion that it does not exempt the taxable capital component of the Texas franchise tax. Construing U.S. Public Law 86-272 narrowly, stated the Court, the capital component of the franchise tax is not a net income tax under U.S. Public Law 86-272.

In support of its final argument, INOVA argued that having one employee in Texas who spends seven to 10 days per month soliciting orders in the state is *de minimus* and therefore does not create the requisite nexus with the state for franchise tax purposes. However, the Court noted that INOVA has a permanent sales presence in Texas because its employee lives in Texas, works from his home in Texas, and systematically solicits orders for new and existing customers in Texas. This sustained activity, held the Court, is sufficient to satisfy the bright line substantial nexus standard created by the U.S. Supreme Court in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1993), which held that physical presence in a state establishes a sufficient nexus for tax purposes.

Accordingly, the Court held that INOVA was subject to the taxable capital portion of the franchise tax.

Hearing No. 43,218 (May 23, 2005): Equipment Sold With Embedded Software On A Lump Sum Basis Constitutes The Sale Of Tangible Personal Property For Franchise Tax Apportionment Purposes.

In *Hearing No. 43,218*, Administrative Law Judge Eleanor Kim determined that the sale of certain large instruments operated by complex computer and electronic systems with a software system embedded in the equipment's hardware constitutes the sale of tangible personal property for purposes of apportioning the proceeds for franchise tax purposes. The claimant submitted a claim for refund for franchise tax contending that it was entitled to a refund because it had erroneously computed and reported Texas receipts in the franchise tax reports it had filed during the refund period. Claimant had treated the sale of its products as a sale of tangible personal property and reported 100% of the receipts earned from Texas customers as Texas receipts in apportioning its franchise tax. Citing Comptroller Rules 3.549(e)(7) and 3.557(e)(6), Claimant argued that it should have treated the receipts attributable to the software as proceeds from the sale of intangible assets apportionable to the location of the payor.

Claimant cited to two prior rulings in which the Comptroller determined that the issuance of a user license with machinery that contains both operational and application software indicates that software was an element to the sales transaction and may be apportioned separately. Those two letter rulings were overruled on February 5, 2004, upon the issuance of a Taxability Memorandum that stated: "The sale of TPP that has some component of software is a receipt for the sale of TPP, unless the software: (1) is licensed separately from the TPP; (2) is priced separately from the TPP; (3) can be installed by the purchaser; and (4) is not all or part of the operating system of the TPP. If all four criteria are met, the receipt for the software may be apportioned to the location of the payor." STAR Accession No. 200402483L (Feb. 4, 2004).

The ALJ rejected the claimant's argument, citing to the "essence of the transaction" doctrine, which is generally applicable in sales and use tax context. Under that doctrine, according to the ALJ, if the sale of tangible personal property incidentally includes a service, the essence of the transaction is the sale of tangible personal property. Accordingly, receipts from that sale should be apportioned to Texas if the property is delivered to a Texas purchaser. Likewise, if the sale of a service incidentally includes the sale of tangible personal property, the sale should be regarded as a sale of a service with receipts from the sale apportioned to where the service was performed. In the event that neither element is incidental to the other, and each is independently provided and identifiable such that both elements are readily separable, the sale involves both the sale of tangible personal property and the sale of a service. Only in that situation can a single charge be broken into two elements.

In this case, the ALJ determined that claimant's customers only purchase the equipment for use in their manufacturing operations. The mere fact that the claimant licensed the embedded software as part of the sale did not convert the embedded software as a separate sale of software. At its conclusion, the ALJ determined that the Comptroller's prior rulings upon which the claimant relied were incorrectly decided and the 2004 Taxability Memorandum controlled the disposition of the case. The Comptroller also rejected the alternative claim of detrimental reliance.

Hearing No. 44,728 (May 25, 2005): The Statute Of Limitations Extension Requires Payment Of Tax Based On Amounts Originally Reported Without Taking Into Consideration Later Amendments.

In *Hearing No. 44,728*, Administrative Law Judge Eleanor Kim determined that the statute of limitations was not extended in favor of a taxpayer seeking to file a claim for refund. The claimant filed a claim for refund of franchise tax for report year 1999. The original due date was May 15, 1999. Claimant had requested an extension of its due date for that year and remitted an unspecified amount with its extension request. Claimant filed its return on November 15, 1999. The claim for refund was filed October 22, 2003, which was more than four years after the original due date of the return, but within four years from the date the return was actually filed.

The Tax Division argued that the statute of limitations was not properly extended from May 15 to November 15 because the claimant did not remit either 90% of the amount of tax reported as tax due on the report filed on or before November 15, or 100% of the tax reported as due for the previous calendar year, as required by Section 171.202(c)(2) of the Texas Tax Code. Claimant argued that the final tax result reflected in the amended report should be used in determining whether the 90% requirement was satisfied.

The ALJ disagreed with the claimant's argument. According to the ALJ, the Tax Code requires 90% of the amount of tax originally reported as due on the report filed on or before November 15. Amended reports, stated the ALJ, have no relevance to the extension process. Accordingly, the refund claim was denied.

Hearing No. 44,735 (April 6, 2005): Multi-Level Marketing Company Has Nexus With The State Of Texas For Franchise Tax Purposes.

In *Hearing No. 44,735*, the Comptroller continued its aggressive stance on nexus issues involving multi-level marketing companies. In what appears to have become established policy, the Comptroller determined that a multi-level marketing company had nexus with Texas for franchise tax purposes and its activities were not protected by U.S. Public Law 86-272.

The ALJ determined that petitioner's activities within Texas were sufficient to establish nexus for the taxable capital portion of the franchise tax. In support of this determination, the ALJ noted that (1) petitioner sells "memberships" for a fee to Texas customers who receive petitioner's products and the right to use petitioner's services; (2) petitioner offers its Texas members affiliate status financial incentives for new customer referrals; and (3) petitioner's affiliates are independent contractors clearly authorized to act on behalf of petitioner to solicit sales of memberships in Texas and thereby petitioner's goods and services.

The ALJ also ruled that petitioner's activities within the state are not protected by U.S. Public Law 86-272 for purposes of the earned surplus portion of the franchise tax because petitioner's business activities within Texas are not limited to the solicitation of orders for tangible goods. The ALJ determined that Texas customers who paid petitioner's initial membership fee and the mandatory monthly fees received valuable intangible benefits, including access to petitioner's telephone and web-based services, which include customer leads from petitioner's advertising. In addition, the ALJ noted that petitioner offers its Texas affiliates financial incentives to solicit the sale of petitioner's services within the state. According to the ALJ, these services are not protected by U.S. Public Law 86-272. Accordingly, petitioner's multi-level marketing activities were subject to the earned surplus portion of the Texas franchise tax.

Hearing No. 43,503 (April 25, 2005): Activities Of Wisconsin Manufacturer Who Marketed Products Through Network Of Distributors Was Not Entitled To The Protection Of U.S. Public Law 86-272.

In *Hearing No. 43,503*, Administrative Law Judge Roy Scudday determined that a Wisconsin corporation that manufactures air and hydraulic cylinders and pneumatic valves does not qualify for the protection of U.S. Public Law 86-272. Petitioner markets products through a network of fluid power distributors. Specifically, petitioner sells products to the distributors who in turn resell the products to their customers. Petitioner makes no direct sales to Texas and has no office, warehouse or facility of any kind within Texas.

Petitioner maintains a "regional manager" for a seven-state area who resides in Texas. The regional manager does not solicit sales, but will make calls to distributors in his region, including Texas, to describe the product lines and answer any technical questions. One of the regional manager's responsibilities involves meeting with distributors and their customers to "put out fires," which basically involves investigating and providing assistance in resolving complaints.

The ALJ determined that the regional manager's activities do not fall within the protection of U.S. Public Law 86-272 as construed by the U.S. Supreme Court in *Wisconsin Department of Revenue v. Wrigley, Co.*, 505 U.S. 214 (1992). According to the ALJ, resolving customer complaints is not ancillary to the solicitation of orders from distributors, but rather, represents an independent business function of the petitioner. These activities, determined the ALJ, are not protected by U.S. Public Law 86-272 and, therefore, subjected petitioner to the earned surplus portion of the Texas franchise tax.

Sales and Use Tax

Hearing No. 44,981 (April 19, 2005): Equipment Leased On A Month-To-Month Basis Determined Subject To 1% Surcharge Effective September 1, 2001.

In *Hearing No. 44,981*, Administrative Law Judge Roy Scudday determined that leases of two cranes and a forklift were subject to the new surcharge imposed by Section 151.0515(b)[3] which became effective September 1, 2001. That Section imposes a surcharge equal to 1% of the lease or rental amount on the lease or rental of new or used equipment. The taxpayer argued that the two leases were entered into prior to the imposition of the surcharge and were therefore not subject to the surcharge. The Tax Division responded that the leases were month-to-month leases and accordingly the surcharges were due and determined with respect to each monthly payment.

The ALJ rejected the taxpayer's argument and held that the leases were subject to the surcharge. The ALJ noted that the language in the lease agreements provided that rentals were to be paid each month in advance. Accordingly, the leases were month-to-month leases that were automatically renewed each month while the equipment was in the claimant's possession. The ALJ determined that the statute contemplates a 1% surcharge on leases that began or are renewed on or after the effective date of the statute and a 2% surcharge on leases that began or are renewed on or after July 1, 2003. Because the leases in this case were month-to-month leases, the monthly lease payments that became due on renewals on or after September 1, 2001, were subject to the 1% surcharge, and, on or after July 1, 2003, were subject to a 2% surcharge.

Hearing No. 42,834 (April 6, 2005): Lubricants Used On Compressor Engines Used To Compress Gas On Gas Leases Qualify For Manufacturing Exemption.

In *Hearing No. 42,834*, Administrative Law Judge Roy Scudday ruled that certain lubricants used by an oil and gas exploration and production company qualify for the manufacturing exemption. The petitioner purchased the lubricants for use on compressor engines that were used to compress gas on gas leases. It executed contracts establishing that it was required to compress gas at targeted pressures per the specifications of gas purchasers. The contracts further provided schematic drawings of each lease showing the locations of each compressor.

The ALJ determined that, because petitioner was required to compress gas for delivery, the compressors were exempt. The ALJ noted that the schematic drawings established that the purpose for the compressors was to pressurize gas prior to entering the sales lines. As a result, the petitioner established by clear and convincing evidence that the compressors for which the lubricants were purchased qualified for a manufacturing exemption.

Hearing No. 44,429 (March 15, 2005): Electricity Used By Local Telephone Service Provider Does Not Qualify For Either Resale Or Manufacturing Exemptions.

As part of a series of hearings involving a set of substantially identical issues, the Comptroller determined in *Hearing No. 44,429*, that a provider of local telephone services could not claim either the resale or manufacturing exemption for electricity used in the provision of its services. Claimant argued that its purchase of electricity qualifies as tangible personal property that is resold as well as tangible personal property used in manufacturing.

Citing to Comptroller's Decision No. 39,547 (2005) and Comptroller's Decision No. 43,999 (2004), the ALJ determined that the electricity that Claimant purchased was not resold to its customers, but was instead used by claimant in providing taxable telecommunications services. The ALJ also rejected claimant's argument that the electricity qualified for the manufacturing exemption because it was sold for use in powering equipment by a person processing tangible personal property for sale as tangible personal property or alternatively for use in lighting, cooling, and heating a manufacturing area during actual manufacturing. The ALJ rejected these contentions because the electricity was used to power network equipment in order to provide a taxable service. The equipment did not qualify as exempt manufacturing or processing equipment because it did not produce tangible personal property for ultimate sale.

Hearing Nos. 44,466, et al. (May 16, 2005) and Hearing Nos. 44,547, et al. (May 17, 2005): Wireless Telephone Service Providers Could Not Claim Manufacturing Exemption On Either Telephone Network Equipment Or Electricity Used In The Provision Of Services.

In *Hearing Nos. 44,466, et al.* and *44,547, et al.*, Administrative Law Judge Joe Greco addressed certain claims by providers of cellular voice and data telecommunication services regarding the taxability of certain mobile telephone network equipment and electricity used in the provision of their services. The claimants argued in these cases that they were entitled to a refund of tax paid on the purchase of certain mobile telephone network equipment used in the provision of their services on the basis that the equipment qualified for the manufacturing exemption under Section 151.318(a)(2). Claimants also argued that they were entitled to a refund of tax paid on electricity used to power the mobile telephone network equipment on the basis of Section 151.317. The ALJ rejected each of these arguments.

In support of their first contention, claimants acknowledged that they sold taxable telecommunication services, but argued that the mobile telephone network equipment qualified for the manufacturing exemption because claimants used the equipment to process their customer's signal in providing their services. Specifically, claimants argued that (1) the electrical voice signals constituted tangible personal property; (2) the equipment is used in and during the manufacturing of radio signals and causes a physical change to the radio signals; (3) the processing of a voice signal represents a sale of tangible personal property; and (4) the manufactured voice signals are transferred to customers as an integral part of the telecommunication service.

In addressing claimants' first argument, the ALJ noted that this issue was recently decided in Comptroller Decision No. 43,999 (2004), in which the Comptroller determined that the telecommunications services provider's network equipment did not produce tangible personal property for ultimate sale, and therefore, the exemption provided to manufacturers under Section 151.318(a)(2) did not apply because that exemption is limited to necessary or essential equipment that does so.

The ALJ also rejected claimants' assertion that electrical voice signals were being sold as an integral part of its telecommunications services and its further assertion that care, custody and control of voice signals were transferred to customers, thus evidencing a "sale of tangible personal property." According to the ALJ, the former allegation pertains to the "sale for resale" definition found in Section 151.006(1) and the latter to the sale for resale exemption provided for in Section 151.302(2). In either instance, the ALJ stated that one must first purchase an item of tangible personal property, which was obviously not applicable in these cases. For these same reasons, the ALJ rejected the claimant's second contention because the manufacturing exemption only applies to electricity that is used "during the actual manufacturing or processing of tangible personal property for sale as tangible personal property."

Hearing No. 44,736 (March 15, 2005): Multi-Level Marketing Company Had Nexus With The State of Texas For Sales and Use Tax Collection Purposes.

In *Hearing No. 44,736*, Administrative Law Judge Ann Perez determined that a multi-level marketing company had nexus with the state of Texas for sales and use tax collection purposes.

In determining whether petitioner had nexus for sales tax purposes, the ALJ noted that the petitioner sells "memberships" for a fee to Texas customers, who receive the described tangible personal property, as well as the right to access petitioner's services. Petitioner also offers its Texas members with affiliate status financial incentives for new customer referrals to petitioner. In addition, petitioner's affiliates are independent contractors who are authorized to act on behalf of petitioner to solicit sales of memberships in Texas as well as petitioner's goods and services. Under these facts, the ALJ determined that petitioner's activities in Texas caused it to be a "retailer engaged in business in the State" as contemplated by Section 151.107. Petitioner's solicitation of business in Texas through independent contractors, stated the ALJ, makes it a retailer in Texas.

Acknowledging that the U.S. Supreme Court in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), recognized the "sharp distinction . . . between mail order sellers with retail outlets, solicitors, or property within a state, and those who do no more than communicate with customers in the state by mail or common carrier," the ALJ determined that petitioner's contacts in Texas were not limited to delivery of products by mail. Rather, petitioner was found to maintain a presence in Texas through its independent contractors authorized to solicit sales on petitioner's behalf. Accordingly, petitioner was found to have substantial nexus with Texas for sales and use tax purposes.

This decision, along with *Hearing No. 44,735* (discussed above), continues the trend set by the Third Court of Appeals in Austin, Texas in *Alpine Industries v. Strayhorn*, 2004 WL 1573159 (Tex. App.—Austin 2004, pet. denied). In that case, the Court held that a Tennessee air purifier manufacturer with a network of "independent salespersons" located in Texas was a multi-level marketing/direct sales company and that the mere fact that they had a large number of independent contractors working in Texas established nexus thereby causing Alpine to have nexus for sales tax purposes.

<u>Procedure and Administration</u>

Strayhorn v. Willow Creek Res., Inc., 161 S.W.3d 716 (Tex. App.—Austin March 24, 2005, no pet.): Informal Review Of Claim For Refund Constitutes "Administrative Proceeding" For Purposes Of Tolling The Statute Of Limitations Under Pre-2003 Law.

In a case involving claims for refund of gas production taxes, the Court of Appeals in Austin, Texas held that the statute of limitations is tolled for the period during which a claim for refund is under informal review by the Texas Comptroller. While the case does not involve sales and use tax or franchise tax, its holding is equally applicable to other taxes administered by the Texas Comptroller. However, the reader should keep in mind that the statutory provision at issue in this case, Section 111.207(a) was amended in 2003 thereby significantly diminishing the significance of the court's holding.

The taxpayer was a company by the name of Willow Creek.[4] Willow Creek filed three claims for refund over a three-year period. The first was filed on April 17, 2000, the second on December 6, 2001, and the third on July 1, 2002. The Comptroller granted the first two claims for refund but disallowed a portion of the third on the basis that the request was filed after the four year statute of limitations had expired. The parties agreed that the Comptroller's informal review of the first claim lasted approximately nine months. They further agreed that if the statute of limitations was tolled during this period of time, Willow Creek would be entitled to the full amount of its refund claim. The issue, therefore, was whether the statute of limitations was in fact tolled during the period of the Comptroller's informal review of the first claim for refund.

At issue was the language in Section 111.207(d) which at the time stated in relevant part, "[I]n determining the expiration date for filing a refund claim for a tax imposed by this title, the period during which an administrative proceeding is pending before the Comptroller for the same period and type of tax is not considered . . . ." The Comptroller argued that the informal review of a tax refund request does not constitute an administrative proceeding. Therefore, the Comptroller argued that the informal disposition of Willow Creek's first claim did not operate to toll the statute of limitations for purposes of the third claim for refund. In support of its argument, the Comptroller raised a number of arguments that the Court considered and rejected.

The Comptroller's first argument was that Section 111.1042, which was added by the Legislature in 1993, clarifies that the informal review of a tax refund claim is not an administrative proceeding. The Court disagreed with the Comptroller noting that Section 111.1042 was added to the Tax Code as a result of the Court's holding in *Bullock v. Sage Energy Co.*, 728 S.W.2d 465 (Tex. App. — Austin 1987, writ ref'd. n.r.e.), which had the effect of generating thousands of refund claims by taxpayers. According to the Court, Section 111.1042 served the purpose of statutorily authorizing the informal review and disposition procedures that were instituted by the Comptroller following *Sage Energy*. The Court did not find any indication in the legislative history that would lead it to conclude that the purpose for enacting this section was to limit the scope of the tolling provision in Section 111.207(d) to contested cases or hearings, as suggested by the Comptroller.

The Comptroller raised three additional arguments that the Court likewise considered and rejected. Specifically, the Comptroller argued that (1) an administrative proceeding is synonymous with an evidentiary or an adjudicatory hearing before an agency; (2) construing a term "administrative proceeding" to include the informal review of tax refund claims creates conflict with other statutes; and (3) the Court should adopt the Comptroller's construction that an informal review of a tax refund claim is not an administrative proceeding.

The Court noted that the Texas Supreme Court has similarly characterized other informal proceedings, citing *Texas Department of Transportation v. Jones Bros. Dirt and Paving Contractors, Inc.*, 92 S.W.3d 477 (Tex. 2002). In the *Jones Brothers* case, the Supreme Court analyzed a provision of the Transportation Code, which authorizes the Transportation Commission to develop informal procedures for the resolution of contract claims. The Court noted that the Supreme Court in *Jones Brothers* characterized the informal review and denial of the contract claims at issue in that case as an administrative proceeding.

The Comptroller also argued that the Court should apply the three-part test articulated by the Alaska Supreme Court in *Hickel v. Halford*, 872 P.2d, 171, 178 (Alaska 1994) to the facts of this case. Noting that the Alaska Supreme Court's holding in *Hickel* is not binding on Texas courts, the Court of Appeals nevertheless concluded that the informal review of Willow Creek's first tax refund claim satisfied the *Hickel* definition of an administrative proceeding. After considering each of the elements set forth in *Hickel*, the Court concluded that a refund claim that meets the requirements of the Texas Tax Code and provides the Comptroller with the documentation necessary to verify the claim will satisfy the three-part test set forth in *Hickel*.

The Court also rejected the Comptroller's argument that construing the term "administrative proceeding" to include the informal review and disposition of refund claims creates a conflict with other statutory provisions. On the contrary, the Court held that construing the term "administrative proceeding" to preclude an informal review of a tax refund claim could potentially render Section 111.1042 meaningless. The possibility exists, stated the Court, that the Comptroller may deny a refund claim following an informal review.

The Court noted that the Comptroller, in this case, took approximately nine months to review and partially grant Willow Creek's first claim. If the Comptroller had ultimately denied Willow Creek's claim, Willow Creek would not have been able to request a formal hearing if the statute of limitations had continued to run while the Comptroller reviewed the claim. Accordingly, Section 111.1042, held the Court, is meaningless unless the term "administrative proceeding" is construed to include this type of informal review and disposition.

The Comptroller further argued that if the term "administrative proceeding" is construed to include informal reviews of claims for refund, further litigation would ensue to determine the line between agency actions that toll the statute of limitations and those that do not. The Court disagreed noting that a construction of the term "administrative proceeding" that includes an informal review of tax refund claims would only include refund claims that meet the statutory requirements set forth in the Tax Code. In addition, the Court noted that Section 111.207 was amended in 2003 to limit the tolling provision to administrative redeterminations and refund hearings rather than administrative proceedings. As such, stated the Court, it is unlikely that there will be further litigation concerning the scope of the term "administrative proceeding" in this context.

As a final matter, the Comptroller argued that the Court should defer to its interpretation of Section 111.207(d). The Comptroller noted that following the legislature's enactment of Section 111.1042(b), which states that the informal review of a tax refund claim is neither a contested case nor a hearing, the Comptroller determined that an informal review also does not qualify as an administrative proceeding. The

Court rejected this argument holding that "ascertaining and discerning the legislature's intent in an act in Section 111.1042 is not a task within the Comptroller's administrative expertise." Accordingly, the Comptroller is entitled to a lessened level of deference, stated the Court. Because the Comptroller failed to provide the Court with evidence establishing that the legislative purpose for enacting Section 111.1042 was to limit the application of former Section 111.207(d)'s tolling provision to contested cases or hearings, the Court declined to adopt the Comptroller's construction period.

The Court therefore concluded that the term "administrative proceeding" can be used to describe the informal adjudication of a tax refund dispute regardless of whether a hearing is held. Because the informal review and disposition of a tax refund claim constitutes an administrative proceeding, the Court affirmed the district court's summary judgment in favor of Willow Creek.

Local Neon Co. v. Strayhorn, No. 03-04-00261-CV, 2005 WL 1412171 (Tex. App.—Austin June 16, 2005, no pet.): While Protest Letter Held Insufficient to Invoke Jurisdiction of District Court, UDJA Nevertheless Determined to Permit Declaratory Judgment on Constitutional Claims.

The Third Court of Appeals' recent holding in *Local Neon Co. v. Strayhorn*, reaffirms the need to observe the formalities set forth in the Tax Code for litigation purposes. In *Local Neon*, the Court determined that a protest letter filed by a taxpayer was inadequate to establish jurisdiction for purposes of initiating a lawsuit in District Court. However, the Court also concluded that the taxpayer was nevertheless entitled to seek declaratory judgment relief on its constitutional claims. In so holding, the Court has provided a further articulation of the extent to which a party may seek declaratory relief, and therefore attorney's fees, under the Texas Uniform Declaratory Judgments Act (UDJA).

In this case, the taxpayer Local Neon Company, Inc. (Local Neon) is a California corporation in the business of designing, building, and selling signs to businesses. As a result of an audit, the Comptroller determined that the taxpayer had been doing business in Texas and assessed a sales and use tax deficiency.

Local Neon requested and was granted a redetermination hearing, which resulted in the affirmation of the audit assessment. Following a motion for rehearing that was denied, Local Neon then paid the assessed tax under protest by enclosing a letter that simply stated the amount was being paid "UNDER PROTEST." It then filed a tax protest lawsuit in district court seeking relief under the Texas Tax Code and the Texas Declaratory Judgment Act. Local Neon also sought attorney's fees pursuant to the provisions of the Declaratory Judgment Act.

The Comptroller filed and was granted a plea to the jurisdiction requesting that the district court dismiss the protest suit because the taxpayer failed to submit a protest letter that stated "fully and in detail each reason for recovering the payment" in accordance with Section 112.051(b). The taxpayer appealed this decision arguing (1) the district court had jurisdiction over the tax protest suit because Local Neon's protest letter complied with Section 112.051(b) when viewed in the context of the administrative proceedings, and (2) the district court had no basis for dismissing its declaratory relief claims because Tax Code remedies do not represent exclusive remedies that preclude all actions for declaratory judgment.

The Court agreed with the Comptroller and the district court that the protest in this letter did not meet the requirements of Section 112.051(b). That section states in relevant part, "[t]he protest must be in writing and must state fully and in detail each reason for recovering the payment." According to the Court, the reasons for Local Neon's protest suit were not as clear as the Tax Code requires and therefore did not meet the requirements of the Tax Code.

In connection with its second claim, the Court noted that there were a number of declaratory judgments that Local Neon sought under the Texas Declaratory Judgments Act. With only one exception, the Court determined that Local Neon was not entitled to the declaratory judgments it sought because they each involved matters that could have been raised pursuant to the protest or refund provisions of the Tax Code. Because a declaration on these issues would be redundant of remedies provided for under the Tax Code, Local Neon was not entitled to a declaratory judgment under the UDJA. The District Court's order dismissing these claims was therefore proper.

The Court arrived at a different conclusion with respect to Local Neon's declaration requests regarding the constitutionality of the tax protest statutes and the Comptroller's imposition of tax on Local Neon. Stated the Court: "A request for a declaratory judgment regarding the constitutional validity of an agency rule is distinct from, and therefore not redundant to, a challenge to the correctness of the agency's order pursuant to that rule." The Court noted that the Texas Supreme Court has held that a court can entertain constitutional challenges to the Tax Code raised for the first time in a tax refund because agencies lack the authority to declare the constitutionality of a statute. This same rule should apply to constitutional claims not included in a protest letter, held the Court.

The Court also noted that Local Neon's requests for declarations regarding the constitutionality of the above was more than a ruse to elude the bar of sovereign immunity because Local Neon's requests for a declaration regarding the constitutionality of these statutes and rules does not represent an action that requires the State to pay money damages. Accordingly, the Court determined that the district court erred in dismissing Local Neon's declaratory relief regarding these constitutional claims and the associated claims for attorney's fees.

ENDNOTES

1. Meadows, Owens, Collier, Reed, Cousins & Blau, LLP. DColmenero@meadowsowens.com. The author thanks Clayton Ketter, a law student at Southern Methodist University, for his assistance with this article.
2. As noted by the Court, the throwback provision was added to the Code to take advantage of the fact that U.S. Public Law 86-272 could have the effect of leaving a significant portion of net income from interstate commerce untaxed by any state. Under the throwback rule, these receipts are thrown back to Texas for inclusion in the Texas franchise tax computations where the business has nexus with the state.
3. All section references are to the Texas Tax Code unless otherwise specified.
4. On July 12, 2000, Willow Creek appointed Trinity Petroleum Consultants, Ltd. (Trinity) as its attorney-in-fact authorizing Trinity to seek a refund of gas production taxes paid by Willow Creek. For the sake of clarity, the court refers to all refund claims as if made by Willow Creek. The same reference is used in this article.

RECENT DEVELOPMENTS APPLICABLE TO TAX-EXEMPT ORGANIZATIONS

Tyree Collier[1]

The following is a summary of selected recent developments in the law applicable to tax-exempt organizations, prepared by Tyree Collier for the 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.

A. Senate Finance Committee Developments. Senate Finance Committee staff indicated over the Summer that other projects had recently taken precedence over the committee's work on exempt organizations legislation. They indicated, however, that legislation would be completed and should be introduced in the Fall of 2005.

B. Applications for Exemption for "Type III" Supporting Organizations. Since early Summer, the IRS has been sending all applications for exemption for "Type III" (i.e., "operated in connection with") supporting organizations to a small group of reviewers in Cincinnati. Many practitioners believe this review group will not make these applications a priority until there are further developments from the legislation being drafted by the Senate Finance Committee.

C. Independent Sector's Panel on the Nonprofit Sector Releases Final Report. On June 22, 2005, the Panel on the Nonprofit Sector convened by Independent Sector released its final report, titled "Strengthening Transparency, Governance, Accountability of Charitable Organizations." The Panel was convened in late 2004 at the request of Senator Grassley and other leaders of the Senate Finance Committee. The Panel's final report follows several earlier recommendations and proposals provided by other groups for possible changes to the federal income tax rules applicable to tax-exempt organizations. Those earlier proposals included reports by the Senate Finance Committee staff and the Joint Committee on Taxation, both of which are discussed in previous issues of *The Texas Tax Lawyer*. The Panel also provided a preliminary report earlier in 2005, which was also discussed in an earlier issue of *The Texas Tax Lawyer*.

The Panel's final report makes 15 primary recommendations, not only for amending the federal income tax rules applicable to charitable tax-exempt organizations, but also for enforcing such rules and for amending and enforcing other rules applicable to charitable tax-exempt organizations. The final report describes overarching principles that guided its recommendations, including that the charitable community must remain vibrant and independent, the charitable community must demonstrate integrity and credibility by providing accurate and comprehensive information and through self-regulation and education, and governments should effectively enforce their laws and deter abuse without discouraging legitimate charitable activities and while keeping in mind the more limited resources of some organizations.

The Panel's final report recommends fewer amendments to the federal income tax laws than do the proposals authored by the Senate Finance Committee staff and the Joint Committee on Taxation. Based on comments made by committee members and staff, the Senate Finance Committee may not limit its draft legislation to the recommendations made by the Panel. It seems likely, however, that the draft legislation will at a minimum include many of the Panel's recommendations for amendments to the federal income laws. This is because the committee members and staff may view these recommendations as less likely to draw objections, given that a significant group of exempt organization representatives have recommended them, although some of the Panel's recommendations have already been criticized by other groups of nonprofit organizations. The Panel's recommendations are as follows:

1. *Funding and Enforcement*. Congress should increase funding of the IRS for overall tax enforcement and oversight of charitable organizations, should create a federally funded program to help states in their efforts to oversee charities, and should eliminate statutory barriers that prevent the IRS from sharing information with state charity officials.

2. *Reporting*. The annual information returns (Form 990 series) filed by charitable organizations should be improved so that they provide more useful information; electronic filing of returns should be required; Congress should impose penalties on return preparers who willfully omit or misrepresent information on returns; an organization's highest ranking officer should be required to sign and certify the return, which should be reviewed by the board or an appropriate committee; even small organizations should be required to file a short form return; and organizations that fail to correct inaccurate or incomplete returns for two consecutive years should have their exempt status suspended.

3. *Periodic Review*. Congress should not require organizations to re-apply for exemptions periodically but instead should allow the IRS to focus its resources on review and investigation of annual returns; however, boards of charitable organizations are encouraged to undertake a full review of their governing documents and policies at least once every five years.

4. *Financial Audits and Reviews*. Congress should require organizations with at least $1 million in annual revenues to attach audited financial statements to their Form 990 series returns and should require organizations with annual revenues between $250,000 and $1 million to have their financial statements reviewed by an independent public accountant.

5. *Performance Data*. While Congress should not require the Form 990 series returns to contain more detailed statements of program evaluations or performance measures, it is recommended that charitable organizations provide more detailed information about their operations through their annual report, website, and other means.

6. *Donor-Advised Funds*. Congress should strengthen regulations governing donor-advised funds in a number of ways, including requiring donor-advised funds to make minimum distributions of 5% of aggregate funds while enforcing minimum individual fund activity requirements, requiring written agreements with donors as a pre-requisite for deductibility of contributions, prohibiting the payment of funds to private foundations and directly or indirectly to donors, advisors, and related parties, and imposing penalties on donors, advisors, and managers who violate such prohibitions.

7. *Type III Supporting Organizations*. Congress should not eliminate Type III ("operated in connection with") supporting organizations, but instead should establish additional rules applicable to such organizations, including minimum distribution requirements, a prohibition against payment of funds to or for the benefit of any donor or related party, a limit of five supported organizations, a prohibition against supporting an organization controlled by the donor or a related party, and certain requirements for reporting to supported organizations.

8. *Abusive Tax Shelters*. Congress should make clear that exempt organizations are subject to reporting rules regarding abusive tax shelters and should impose penalties on organization managers who fail to comply with such rules when they know or should have known a transaction was a reportable transaction; Congress should also impose penalties on taxable participants and material advisors who fail to notify exempt organizations that they would be engaging in reportable transactions.

9. *Non-Cash Contributions*. Congress should strengthen rules for appraisals used to substantiate charitable contributions of non-cash contributions and should impose penalties on appraisers who knowingly provide overstated appraisals; Congress should also strengthen rules regarding conservation and historic facade easements and should not impose an arbitrary limit on the amount that can be deducted for contributions of clothing and household items.

10. *Board Compensation*. While compensation of board members is discouraged, charitable organizations that do provide board member compensation should be required to disclose amounts of and reasons for such compensation and the method used to determine the reasonableness of such compensation; Congress should also prohibit loans to board members of public charities and should increase penalties on board members who approve or receive excessive compensation.

11. *Executive Compensation*. Charitable organizations should be required to more fully disclose the compensation paid to their chief executive officer, other disqualified persons, and their five highest paid employees; recipients of compensation should be required by Congress to demonstrate their compensation is reasonable; and penalties should be imposed on board members and managers who approve unreasonable compensation without following the rebutable presumption procedures under the Section 4958 regulations.

12. *Travel Expenses*. Charitable organizations paying or reimbursing travel expenses for anyone should establish and enforce policies including the type of expenses that are reimbursable and the documentation required; no such payment or reimbursement should be provided for spouses or dependents; certain disclosures should be required on annual returns regarding travel expense policies.

13. *Composition of Governing Boards*. All 501(c)(3) organizations should have a minimum of three persons on their governing boards; all public charities should be required to have at least one third of their governing board be composed of independent members; all charitable organizations should be required to disclose which board members are independent; persons barred from service on the boards of taxable entities should also be barred from serving on the boards of charitable organizations; charitable organizations should periodically review board size and should establish requirements for board responsibilities.

14. *Audit Committees*. Charitable organizations should include board members who have some financial literacy and should consider establishing separate audit committees.

15. *Conflicts of Interest and Misconduct*. Charitable organizations should adopt and enforce a conflict of interest policy and the IRS should require every Form 990 series return to disclose whether an organization has such a policy; charitable organizations should adopt policies and procedures to encourage and protect individuals who come forward with credible information regarding illegal practices or violations of adopted policies.

D. <u>IRS Revising Form 990</u>. IRS representatives informed the Senate Finance Committee in a June 2005 hearing that they are considering a "complete overhaul" of Form 990, with the goal of making the form a better enforcement tool and providing the public and state officials with more relevant information. The Form 990 for 2005 will likely have only a few changes, primarily addressing easement issues, with more significant changes coming in 2006.

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NEW U.S./JAPANESE TREATY DESIGNED TO REVITALIZE INVESTMENTS FLOWS

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On March 30, 2004, a new income tax treaty between Japan and the United States entered into force and is applicable on or after January 1, 2005. The provisions concerning withholding taxes are applicable to amounts paid or credited on or after July 1, 2004 for U.S. withholding taxes and for amounts taxable on or after July 1, 2004 for Japanese withholding taxes. This article provides a summary of the most notable provisions of the treaty.

The treaty contains the standard "saving clause" included in U.S. tax treaties to which each country retains the right to tax its residents and citizens as if the treaty had not come into effect (Article 1). The treaty also contains the standard provision that the treaty may not be applied to deny any taxpayer any benefits the taxpayer would be entitled under the domestic law of a country or under any other agreement between the two countries (Article 1).

The principal purposes of the treaty are to reduce or eliminate double taxation of income earned by residents of either country from sources within the other country and to prevent avoidance or evasion of the taxes of the two countries. As in other U.S. tax treaties, the reduction or elimination of double taxation is achieved through each country's agreement to limit its right to tax income derived from its territory by residents of the other country. The treaty contains provisions in which each country agrees not to tax business income derived from sources within that country by residents of the other country unless the business activities in the taxing country are substantial to constitute a permanent establishment (Article 7). The treaty contains the "commercial visitor" exemption in which residents of one country performing personal services in the other country will not be required to pay tax in the other country unless their contact with the other country exceeds certain minimums (Articles 14 and 16).

The treaty broadly reduces the taxation in the source country of investment income with respect to dividends, interest and royalties (Articles 10, 11 and 12, respectively). The treaty also provides an exemption from branch level interest tax on financial institutions and an exemption from the U.S. insurance excise tax on foreign insurers and reinsurers. In situations under which the country of source retains the right to tax income derived by residents of the other country, the treaty provides for relief from double taxation through the allowance by the country of residence of a tax credit for certain foreign taxes paid to the other country (Article 23).

Intercorporate dividends are exempt from withholding tax if the recipient owns at least 50 % of the payer's voting stock for 12 months. For the exemption, the company receiving the dividend either (1) qualifies for treaty benefits under the "publicly traded" test of the anti-treaty-shopping provision (Article 22, para. 1(c)), (2) satisfies both the "ownership/base-erosion" and the "active trade or business" tests (Article 22, para. 1(f) and (2)), or (3) is granted eligibility for the exemption by the competent authorities (Article 22, para. 4).

The principal effects of a zero-rate provision on U.S. taxpayers and the U.S. fisc would be to (1) relieve U.S. corporations of the burden of Japanese withholding taxes on dividends received from Japanese subsidiaries, (2) relieve the U.S. fisc of the requirement to allow foreign tax credits with respect to these dividends and (3) eliminate the withholding tax revenues collected by the U.S. fisc with respect to dividends received by Japanese corporations from U.S. subsidiaries. The elimination of withholding tax is intended to reduce the tax barriers to direct investment between the two countries.

Otherwise, the withholding tax would be 5% if the recipient owns at least 10% of the voting stock. Portfolio dividends would be subject to a 10% withholding tax. The withholding tax on interest is 10%, but certain interest is exempt.

Royalties from intangible property are exempt from withholding tax. The active use of intangible property and intellectual property may become a factor in the revitalization of Japan's economy. The Japanese government hopes that U.S. and European firms with valuable intangible property will increase direct investment into Japan.

Gains directly derived by a resident of Japan from the sale of U.S. real property may be taxed under the U.S. FIRPTA rules (Foreign Investment in Real Property Tax Act). Also, the treaty preserves U.S. taxing authority under FIRPTA rules on gains from the indirect sale of property through entities holding U.S. real property. Under the treaty, the testing of whether a domestic company is a U.S. real property holding company is performed on the disposition date and not throughout the 5-year period under FIRPTA. A Japanese resident would not be subject to U.S. tax on the sale of stock of a domestic corporation if, at the time of the stock sale, interest in U.S. real property comprise less than 50% of the value of the company assets. Without the treaty, U.S. tax would be imposed on the sale if, at any time over the prior 5 years, 50% or more of the company's assets consisted of real property.

In addition, under the treaty, there is more aggressive Japanese tax enforcement regarding cross-border transactions. Provisions can operate to deny the reduced withholding tax benefits in connection with certain conduit arrangements. The treaty also contains a detailed limitation-of-benefits provision to prevent the inappropriate use of the treaty by third-country residents (Article 22).

The treaty provides a limitation on the period for transfer pricing assessments. The treaty clarifies treaty application of business entities that are treated differently for tax purposes in each country and prevents tax avoidance through the use of silent partnerships (*tokumei kumiai*, or TK). The profit distributions from a TK will now be taxable under Japanese domestic law.

The new treaty is intended to revitalize the Japanese economy by the expansion of direct and indirect investment and business opportunities, increases in employment and the promotion of competition. Also, this new treaty represents Japan's new model for its treaty network. This new treaty has placed pressure on other countries to renegotiate their treaty networks to meet the worldwide competition for global investment funds.

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INDIVIDUAL TAX PLANNING TIPS WITH 15% STOCK DIVIDEND TAX RATE BEFORE IT EXPIRES IN 2008

E. Rhett Buck, Attorney-CPA

The 2003 Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) cut the tax rate to 15% for qualified dividends received during 2003 through 2008 by individuals who are in tax brackets above 15%. JGTRRA also reduced the rate to 5% for 2003 through 2007 and 0% in 2008 for those individuals in the 10% or 15% income tax brackets. Under prior law, dividend income was subject to tax at rates as high as 39.6%.

Qualified dividends eligible for the lower 15% rate include dividends from domestic corporations and from qualified foreign corporations, including U.S. possessions corporations, corporations of foreign countries party to comprehensive U.S. income tax treaties, and stock of foreign corporations traded on U.S. securities markets, for stock owned within 60 days of the ex-dividend date.

The more favorable lower rates provided by JGTRRA will go back up again after 2008, at which time the top tax rates for individuals on stock dividends will increase up to 35%. Therefore, individuals who qualify for the lower dividend tax rate should consider the following planning tips to maximize their tax savings before this valuable tax benefit expires.

<u>Minimize Wages</u>. C corporations should minimize salaries paid to shareholder managers, and pay out dividends to the extent of earnings and profits (E&P). This would cause the shareholder manager to be subject to the more favorable dividend tax rate instead of the higher ordinary rate imposed on salaries or wages. Payroll taxes also would be alleviated. Other techniques C corporation owners can utilize to reduce taxes include structuring debt (shareholder loans to the corporation) and leases (shareholders own assets and lease them to the corporation) to obtain non-wage income.

<u>C Corporations that elected to be S Corporations</u>. S corporation shareholders should consider that, to the extent the S corporation has positive AAA (Accumulated Adjustments Account), there is no tax due on repayment of capital. However, S corporations that have accumulated E&P from prior years as a C corporation may pay out dividends and take advantage of the preferential 15% tax rate. C corporations that were profitable before electing S corporation status (and therefore have accumulated C corporation E&P) may pay out the accumulated C corporation E&P as low-taxed dividends by electing under Section 1368(e)(3) to distribute C corporation E&P first. This also presents an opportunity for S corporations with excess passive income to eliminate the risk of losing S election status due to excess passive income. Under Section 1375, S corporations with more than 25% gross receipts from passive investment income and accumulated C corporation E&P from years prior to its S election are liable for a penalty tax of 35% and lose their S election status if the problem persists for 3 consecutive years. Therefore, practitioners should advise paying out all C corporation E&P to eliminate this recurring annual tax headache and to preserve the corporation's S election.

<u>Constructive and "in lieu" dividends</u>. Despite the new preferential rates, no guidance is provided as to whether constructive dividends (for example, corporate payment of shareholders' personal expenses) qualify for the lower rate. In lieu dividends are not eligible for the lower 15% rate.

<u>Extraordinary dividends</u>. JGTRRA also provided a new rule relating to losses on extraordinary dividends. Under the new current law, dividends that exceed 10% of a shareholder's basis in the stock are extraordinary dividends and any loss on a subsequent sale of the stock is treated as a long-term loss, to the extent of such dividends. Prior law required treatment as short-term loss or ordinary income.

<u>Investment interest expense elections</u>. In certain circumstances, taxpayers may want to forego using the lower rate imposed on dividends. For example, taxpayers with investment interest expense may elect to treat qualifying dividends as ordinary investment income in order to use investment interest expense deductions that would be otherwise lost. The election may be made annually, and only partially to the extent needed to offset investment interest expense on Form 4952.

<u>Redemptions</u>. Under Section 302, distributions from a corporation to redeem a shareholder's stock may be equivalent to a dividend if the redemption is pro rata among all the shareholders. Therefore, the lower rates could be utilized and would be beneficial.

<u>15% Lower Rate Also Applicable to Other Income Items</u>. The tax rate on accumulated earnings tax, personal holding tax, disposition of Section 306 preferred stock, but not most REIT and RIC dividends, is also reduced to 15%.

Under prior law, excess accumulated earnings of corporations (which should have been distributed and taxed as ordinary income dividends to shareholders) were taxed at the highest individual income tax rate. Under Section 541, the undistributed income of a corporation that is a personal holding company (a corporation that receives and holds the personal investment or compensation income of a shareholder) also was taxed at the highest individual income tax rate. And also under prior law, any tax resulting under Section 306 resulted in tax imposed at ordinary income rates. Great opportunities exist for shareholders of closely held corporations to pay out stored values of accumulated earnings, personal holding companies, and Section 306 stock through 2008.

<u>Collapsible corporations</u>. The collapsible corporation rules are repealed through 2008. The collapsible corporation rules were designed to prevent taxpayers from converting ordinary income into capital gains in certain cases. Because capital gains and ordinary income are taxed at the same tax rates now, there was no reason to keep the collapsible corporation rules in place.

<u>Liquidation or partial liquidation of corporation</u>. An important point for practitioners to remember is that the payout of accumulated E&P (which would be taxed at the dividend tax rate of 15%) versus a sale of stock or assets (which may be taxed at the capital gains tax rate of 15%) are not equal alternatives because the capital gain calculation includes reduction for basis.

<u>Reposition portfolios</u>. Dividend paying stock should be in non-qualified plans or accounts, and interest paying securities should be in qualified plans. This is because investor demand should be greater for dividend paying

stocks. Also considering the higher contribution limits now allowed for deferred plans, there may be increasing market stimulus for stocks.

Earnings and Profits. Sufficient E&P is the key to maximizing the new dividend tax reduction opportunities. However, E&P is not clearly defined under the Code, and many corporations have not kept proper records to correctly determine E&P. For many corporations, a comprehensive study and determination of E&P may be in order, and may result in helpful redeterminations of corporate E&P so as to utilize the lower preferential rates through 2008.

Kiddie Tax. Individuals may find it advantageous to put stock in their children's name to avoid all tax on dividends (if the child is less than 14 years old and dividend amount is less than $800), or if the dividend amount is $800 or more, file a separate return for the child to use the 5% rate (2003-2007) or 0% rate (2008) if the child is in the 10% or 15% income tax bracket.

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