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Back to Table of Contents

TO MOVE DIRECTLY TO AN ARTICLE CLICK ON THE TITLE

TABLE OF CONTENTS

FROM OUR LEADER:

- The Chair's Message
  Tina R. Green, Capshaw Green PLLC

SPECIAL RECOGNITIONS, UPCOMING EVENTS, AND SECTION INFORMATION:

- Leadership Roster (2012-2013)
- Committee Chairs and Vice Chairs (2012-2013)
- Calendar of Events for 2012-2013
- Nominating Committee (2012-2013)
- Nomination Forms for 2013 Outstanding Texas Tax Lawyer
- Committee Selection Form
- Rules for Annual Law Student Paper Competition

ARTICLES:

- Transcript of Interview with Texas Tax Legend Charles Hall
- An Introduction To Target Allocations
  Dan G. Baucum, Shackelford, Melton & McKinley, LLP
- How to Structure An Asset Sale As A Stock Sale For Tax Purposes
  David S. Peck, Vinson & Elkins LLP
  Alexander S. Farr, Vinson & Elkins LLP
- Tax Exemptions For Charitable Single-Member Limited Liability Companies
  Terri Lynn Helge, Texas Wesleyan School of Law
  David M. Rosenberg, Thompson & Knight LLP

Back to Table of Contents

- The Nexus Hokey Pokey: Are you in? Are you out? Do you shake it all about?
  Christi A. Mondrik, CPA, Esq., Mondrik & Associates
  Nancy Prosser, Esq., Texas Comptroller of Public Accounts

- Decanting Irrevocable Trusts
  Melissa J. Willms, Davis & Willms, PLLC

PRACTITIONER'S CORNER:

- Recent Developments in Federal Income Taxation
  Ira B. Shepard, Professor Emeritus of Law, University of Houston Law Center

- Texas State Tax For the Oil and Gas Industry, Including Updates for 2012
  Christina A. Mondrick, CPA, Esq., Mondrik & Associates

COMMITTEE ON GOVERNMENT SUBMISSIONS:

- State Bar of Texas, Section of Taxation Comments to Internal Revenue Service on Proposed Regulation Relating to Property Transferred In Connection With The Performance Of Service Under Section 83 Of The Internal Revenue Code, September 26, 2012
  Heather C. Panick, Jackson Lewis LLP
  Henry Talavera, Polsinelli Shughard LLP
  Jeffry Blair, Hunton & Williams LLP

- State Bar of Texas, Section of Taxation Response to Comptroller Request For Comments Concerning Proposed Amendments to Rules 3.1 and 3.10, August 23, 2012
  Ira Lipstet, DuBois, Bryant & Campbell, LLP
  Charolette Noel, Jones Day
  Sam Megally, K&L Gates LLP
  Matt Hunsaker, Baker Botts

- State Bar of Texas, Section of Taxation Response to Comptroller Request For Comments Concerning Proposed Amendments to Rule 3.325, August 23, 2012
  Ira Lipstet, DuBois, Bryant & Campbell, LLP
  Charolette Noel, Jones Day
  Sam Megally, K&L Gates LLP
  Matt Hunsaker, Baker Botts

ANNUAL LAW STUDENT PAPER COMPETITION:

- State Bar of Texas Tax Section's 2012 Annual Law Student Tax Paper Competition, 1st Place Winning Submission, The Carried Interest Debate: Stop Splitting Hairs and Start Splitting Babies
  Ian Jelsma, University of Houston

- State Bar of Texas Tax Section's 2012 Annual Law Student Tax Paper Competition, 2nd Place Winning Submission, Prohibiting the Garden Because You Can't See the Curb – the IRS's Inconsistent Enforcement of the 501(c)(3) Prohibitions
  Jonathan Ellis, Texas Tech

- State Bar of Texas Tax Section's 2012 Annual Law Student Tax Paper Competition, 3rd Place Winning Submission , The Regressive Monster – Resolving Issues With The Added Tax
  Kausthub Kumar, University of Houston

- State Bar of Texas Tax Section's 2012 Annual Law Student Tax Paper Competition, 3rd Place Winning Submission, Repealing Oil and Gas Tax Subsidies: A Taxation Anomaly and Alternative Energy Barrier
  Annie Kwan, University of Houston

Back to Table of Contents

Chair's Message

Thank you for the privilege of serving as the 2012-2013 Chair of the Section of Taxation of the State Bar of Texas. Things are already off to a fast start thanks to the hard work of my fellow officers, Elizabeth Copeland (Chair-Elect), Andrius Kontrimas (Secretary), and Alyson Outenreath (Treasurer), as well as the efforts of all of our Council Members, Committee Chairs, Vice-Chairs, and the many other members who volunteer, without whom our Section could not be a success.

Continuation of New Programs. Once again, we find ourselves in the fortunate position of seeing new programs come to fruition which were begun under the leadership of our immediate past Chairs, Mary McNulty and Patrick O'Daniel, specifically:

- **Tax App.** The Section worked with the Computer and Technology Section to develop a Tax App which was rolled out to our members on June 11, 2012, to access Federal and Texas state tax materials on your iPhone®, iPad®, and iPod Touch®. We also have a web-based Tax App for Blackberry®, Android™ and other web-based phone users, which can also be accessed on your desktop computer via the Internet. The Tax App is the first of its kind and gives you fingertip access to the Internal Revenue Code, Treasury Regulations, tax treaties, AFRs, IRS guidance, cases, Texas Tax Code, Texas Administrative Code, and much more! Go to the Section home page at www.texastaxsection.org/ for instructions on installing the new Tax App.

- **Leadership Academy.** We selected 20 young tax lawyers as the inaugural class of the Tax Section's Leadership Academy. The Leadership Academy allows young tax lawyers to develop their leadership skills as well as network with other tax lawyers throughout the state. The criteria for selection was:

  - Three to six years experience;
  - Member of the State Bar of Texas in good standing;
  - Member of the Tax Section of the State Bar of Texas; and
  - Commitment to attend all four sessions.

  The Leadership Academy has already held three (3) meetings, the first in San Antonio, the second at the State Bar of Texas Annual Meeting in Houston, and the third in Austin. The final meeting is scheduled to be held on January 17, 2013, in Dallas.

Back to Table of Contents

Many thanks to David Colmenero for his efforts in spearheading the Leadership Academy, along with the invaluable assistance of Susan House. The Tax Section will select a Leadership Academy class every other year. If you have any questions, please contact David Colmenero at (214) 744-3700 or dcolmenero@meadowscollier.com.

- **List Servs.** When you join a Committee, you will become a member of that Committee's list serv. The list serv provides you with an email forum for sharing tips, concerns, referrals and other matters with your fellow Texas tax lawyers. If you wish to opt out of the list serv, please contact Brent Gardner at (214) 999-4585 or bgardner@gardere.com.

Continuing with the Section's Core Programs. This year, we will continue our core programs for the Tax Section that were started under the leadership of other past chairs, including Gene Wolf, Kevin Thomason, Dan Micciche, and Tyree Collier.

- **COGS Projects.** Under the leadership of our COGS Chair, Stephanie Schroepfer, we have already submitted three COGS projects this year, specifically on: (i) the Texas Comptroller of Public Accounts' proposed amendments to 34 Tex. Admin. Code §§ 3.1 and 3.10, relating to private letter rulings and general information letters and the Taxpayer Bill of Rights; (ii) the Texas Comptroller of Public Accounts' proposed amendments to 34 Tex. Admin. Code § 3.325, relating to practices and procedures concerning refunds and payments under protest; and (iii) the Proposed Regulation relating to property transferred in connection with the performance of service under Section 83 of the Internal Revenue Code. Many thanks to the State and Local Taxation Committee Chair Ira Lipstet, and Vice Chairs Charolette Noel, Sam Megally, Matt Hunsaker, as well as Stephanie Schroepfer, Chair of COGS, for their hard work on the Texas Comptroller proposed amendment projects and to Heather Panick and Henry Talavera, Vice Chairs of the Employee Benefits Committee, along with Jeffry Blair, Chair of the Corporate Tax Committee, Susan A. Wetzel, Chair of the Employee Benefits Committee, and Stephanie Schroepfer for the comment on the Section 83 Proposed Regulation. If you wish to get involved with a COGS project or have ideas for leading one yourself, please contact Stephanie Schroepfer at (713) 651-5591 or sschroepfer@fulbright.com.

- **24/7 Free CLE Library.** The Tax Section has implemented a 24/7 library of free CLE Webcast programs accessible at any time to Section members through the Tax Section website. We now have over 50 CLE audio and video programs available free of charge to our members broken out into the following categories:

    - Compensation and Employee Benefits (1 Seminar)
    - Corporate Tax (2 Seminars)
    - Energy & Natural Resources Tax (2 Seminars)
    - Estate & Gift Tax (5 Seminars)
    - International Tax (11 Seminars)
    - Partnership & Real Estate Tax (7 Seminars)
    - Property Tax (11 Seminars)
    - Small Firm & Solo (2 Seminars)
    - State & Local Tax (3 Seminars)
    - Tax Controversy (8 Seminars)
    - Tax Exempt Organizations (2 Seminars)

    In addition, there are videotaped interviews with Texas Tax Legends, including Charles Hall, David Glickman, Larry Gibbs, Richard Freling, Buford Berry, Ronald Mankoff, and Bob Davis. If you have any questions, please contact Michael Threet, the head of our CLE Committee, at (214) 969-2795 or mthreet@akingump.com.

- **Live CLE.** The Tax Section sponsors and conducts live CLE programs, including the annual Property Tax program, the annual International Tax program, and State and Local Tax Committee events. In addition, the Section co-sponsors various live CLE programs, including the Texas Society of CPAs Free CPE Day and the Advanced Tax Law Program conducted by the TexasBarCLE, which is held each year in August.

    Mark your calendars for our 15th Annual International Tax Symposium to be held at The Center for American and International Law, 5201 Democracy Drive, Plano, Texas, on November 2, 2012. For further information, contact Deidra Hubenak, Chair of the International Tax Committee, at (713) 986-7000 or dhubenak@lrmlaw.com.

- **Pro Bono.** The Tax Section assists pro se taxpayers during Tax Court calendar calls in Dallas, Houston, Lubbock, El Paso, and San Antonio. Check the calendar on the Tax Section's website for the next calendar call in your city and contact Robert Probasco, Pro Bono Chair, at (214) 969-1503 or robert.probasco@tklaw.com. The Tax Section also provides support to appropriate charitable and governmental programs such as Texas C-Bar and VITA.

- **Texas Tax Lawyer.** Thanks to the hard work of Rob Morris, the Tax Section publishes three issues of the Texas Tax Lawyer each year. The Texas Tax Lawyer is distributed to members electronically and, upon request, in hardcopy. The issues include articles on hot topics, substantive outlines from Committee Webcasts, COGS submissions, and annotated forms. Please contact Rob Morris at (713) 651-8404 or rmorris@fulbright.com.

- **Law School Outreach and Paper Competition.** We hold luncheons each year with students at the SMU Dedman, University of Texas, University of Houston, and Texas Tech University Schools of Law. Every other year, we hold luncheons at Baylor, LSU, and South Texas Law Schools. We also would like to hold luncheons periodically at Saint Mary's, Texas Southern, and Texas Wesleyan Law Schools. If you wish to serve as a panelist, please contact the head of our law school student outreach program, Abbey Garber, at (972) 308-7913 or abbey.b.garber@irscounsel.treas.gov.

  Congratulations to Ian Jelsma from the University of Houston Law Center for winning first prize in our Annual Paper Competition for his paper, The Carried Interest Debate: Stop Splitting Hairs and Start Splitting Babies. Second place is awarded to Jonathan Ellis from Texas Tech University School of Law for his paper on Prohibiting the Garden Because You Can't See the Curb – the IRS's Inconsistent Enforcement of the 501(c)(3) Prohibitions. We had a tie for Third place which goes to Kausthub Kumar from the University of Houston Law Center for the article, The Regressive Monster Resolving Issues with the Value Added Tax, and Annie Kwan from the University of Houston Law Center for the article, Repealing Oil and Gas Tax Subsidies: A Taxation Anomaly and Alternative Energy Barrier. Congratulations to all of our winners! You can read their articles in this edition of the newsletter.

  Many thanks to Ron Adzgery for running this year's paper competition. The deadline for submitting papers for the 2012-2013 competition is May 31, 2013. Please see the Tax Section's website for more details.

Back to Table of Contents

- **Outstanding Texas Tax Lawyer.** Congratulations to Emily A. Parker of Thompson & Knight, LLP, for being selected as the Outstanding Texas Tax Lawyer for 2012. This year's nomination form is on our website and is included in this issue of the Texas Tax Lawyer. Nominations must be made by January 15, 2013. Please take a few minutes and consider nominating a worthy individual for this award.

- **Annual Meeting and Tax Legends Lunch.** The Section Annual Meeting this year will be held in Dallas on June 21, 2013. It will include CLE programs and our Legends Lunch. Stay tuned for more information.

Nominating Committee

The Tax Section's nominating committee for 2012-2013 consists of Dan Micciche as Chair and Patrick O'Daniel, Mary McNulty, and me as an ex officio member. Nominations for Chair-Elect, Secretary, Treasurer, or an Elected Council Member position can be submitted to any member of the nominating committee or to any Officer of the Section at any time on or before March 1, 2013.

Act Now/Get Involved

If you are not already involved in the Section's activities, I strongly encourage you to get involved. Contact one of the chairs of the above activities or join a committee. We have included the Committee Selection form in this issue of the Texas Tax Lawyer and have also posted it on the Tax Section's website. Mark one or more committees that you would like to join and send the form to the Committee Chair listed on the form.

If you are not sure who to contact and what would be the best fit for your skills, then email me at tgreen@capshawgreen.com. You will help us build an even stronger Tax Section and have some fun in the process!

Thank you, and I look forward to working with all of you for a great year!

Tina R. Green
2012-2013 Chair

Back to Table of Contents

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Back to Table of Contents

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Back to Table of Contents

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Back to Table of Contents

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Back to Table of Contents

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Back to Table of Contents

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Back to Table of Contents

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Back to Table of Contents

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Back to Table of Contents

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17. Pro Bono	**Robert D. Probasco** Thompson & Knight, LLP One Arts Plaza 1722 Routh Street, Suite 1500 Dallas, Texas 75201-2533 214-969-1503 214-999-9113 (fax) robert.probasco@tklaw.com	**Vicki L. Rees** Glenda Pittman & Associates, P.C. 4807 Spicewood Springs Road Bld. 1, Suite 1140 Austin, Texas 78759 512-499-0902 512-499-0952 (fax) vrees@pittmanfink.com
18. Leadership Academy	**David E. Colmenero** Meadows, Collier, Reed, Cousins, Crouch & Ungerman, LLP 901 Main Street, Suite 3700 Dallas, Texas 75202 214-744-3700 214-747-3732 (fax) dcolmenero@meadowscollier.com	**Ryan Gardner** Kent, Good, Anderson & Bush, P.C. Woodgate I, Suite 200 1121 E.S.E. Loop 323 Tyler, Texas 75701 903-579-7510 903-581-3701 (fax) rgardner@tyler.net

Back to Table of Contents

SECTION OF TAXATION OF THE STATE BAR OF TEXAS
2012-2013
CALENDAR

1	Deadline for Student Paper Competition
7-8	28th Annual Texas Federal Tax Institute – Hyatt Regency Hill Country Resort, San Antonio
14-15 14-15 15	SBOT 2012 Annual Meeting - Houston George R. Brown Convention Center & Hilton Americas Houston Leadership Academy Houston, TX Tax Section Annual Meeting 8:00 am – 1:30 pm (post on website at least 20 days in advance; elect 3 new Council members) Council Retreat Hosted by: Fulbright & Jaworski LLP (Andrius Kontrimas) 1301 McKinney, Suite 5100 Houston, Texas 77010-3095 713-651-5151 2:00 pm – 5:00 pm
12	**Officer's Retreat** Hosted by: Fulbright & Jaworski, LLP (Andrius Kontrimas) 1301 McKinney, Suite 5100 Houston, Texas 77010-3095 713-651-5151 12:00 – 4:00 p.m.
13	Bar Leaders Conference – New Chair and Treasurer Orientation Westin Galleria – Houston 10:00 a.m. – 3:00 p.m.
24	COGS Call 9:00 am Call-in Information: Phone #: 1-866-203-7023 Code #: 713-651-5591
15	Tax Law 101 CLE Westin Hotel Galleria, Dallas, Texas
16-17	30th Annual Advanced Tax Law Course Westin Hotel Galleria, Dallas, Texas

21	COGS Call 9:00 am Call-in Information: Phone #: 1-866-203-7023 Code #: 713-651-5591
31	10:30 a.m. – 12:30 p.m. Council and Committee Chairs and Vice Chairs Meeting **MANDATORY IN PERSON ATTENDANCE** Hosted by: Meadows, Collier, Reed, Cousins, Crouch & Ungerman, LLP (David Colmenero) The City Club 901Main Street Suite 6900 Dallas, Texas 75202 214-744-3700 Call-in Information: Phone #: 1-866-548-4716 Password: 2223040
10	Pro Bono Committee Calendar Call Assistance (small case) United States Tax Court Dallas, Texas Pro Bono Committee Calendar Call Assistance (small case) United States Tax Court San Antonio, Texas
11	Deadline for appointing Nominating Committee (list in *Texas Tax Lawyer* and on website)
18	COGS Call 9:00 am Call-in Information: Phone #: 1-866-203-7023 Code #: 713-651-5591
20-21	Leadership Academy Jackson Walker, LLP 100 Congress Avenue, Suite 1100 Austin, TX 78701
28	Article Deadline - Fall 2012 issue of the *Texas Tax Lawyer*
15	Pro Bono Committee Calendar Call Assistance (regular and small case) United States Tax Court El Paso, Texas
18	Pro Bono Committee Calendar Call Assistance (regular and small case) United States Tax Court Lubbock, Texas

Back to Table of Contents

22	Pro Bono Committee Calendar Call Assistance (regular case) United States Tax court Dallas, Texas
23	COGS Call 9:00 am Call-in Information: Phone #: 1-866-203-7023 Code #: 713-651-5591
26	Publishing Deadline - Fall 2012 Issue of the *Texas Tax Lawyer*
29	Pro Bono Committee Calendar Call Assistance (regular case) United States Tax Court Houston, Texas
2	15th Annual International Tax Symposium The Center for American and International Law 5201 Democracy Drive Plano, Texas 75024
5	Pro Bono Committee Calendar Call Assistance (regular case) United States Tax Court San Antonio, Texas Pro Bono Committee Calendar Call Assistance (regular case) United States Tax Court Houston, Texas
9	10:30 a.m. – 12:30 p.m. Council Meeting Hosted by: Strasburger Price Oppenheimer Blend (Elizabeth Copeland) 720 Brazos Street Austin, Texas 78701 512-499-3600 Call-in Information: Phone #: 1-866-548-4716 Password: 2223040
13	Pro Bono Committee Calendar Call Assistance (regular case) United States Tax Court Dallas, Texas
20	COGS Call 9:00 am Call-in Information: Phone #: 1-866-203-7023 Code #: 713-651-5591
26	Pro Bono Committee Calendar Call Assistance (small case) United States Tax Court Houston, Texas

Back to Table of Contents

3	Pro Bono Committee Calendar Call Assistance (small case) United States Tax Court Houston, Texas
17	Pro Bono Committee Calendar Call Assistance (regular case) United States Tax Court Dallas, Texas Pro Bono Committee Calendar Call Assistance United States Tax Court San Antonio, Texas
18	COGS Call 9:00 am Call-in Information: Phone #: 1-866-203-7023 Code #: 713-651-5591
15	Deadline for annual meeting program agenda Nominations due for Outstanding Texas Tax Lawyer (Council vote follows January 18 meeting)
17 17	Leadership Academy Application deadline Leadership Academy Belo Mansion – Dallas Bar Association 2101 Ross Avenue Dallas, TX 75201
18	**Council and Committee Chairs and Vice Chairs Meeting** 10:30 am – 12:30 pm Hosted by: Akin Gump Strauss Hauer & Feld, LLP (Michael Threet) 1700 Pacific Avenue, Suite 3900 Dallas, Texas 75201 214-969-2795 Call-in Information: Phone #: 1-866-548-4716 Password: 2223040
22	COGS Call 9:00 am Call-in Information: Phone #: 1-866-203-7023 Code #: 713-651-5591
24-26	ABA Tax Section Midyear Meeting Hilton Bonnet Creek & Waldorf Astoria Orlando, Florida
8	Article Deadline - Winter 2013 issue of the *Texas Tax Lawyer*

Back to Table of Contents

10	Tax Court Pro Bono Program Annual Renewal
19	COGS Call 9:00 am Call-in Information: Phone #: 1-866-203-7023 Code #: 713-651-5591
1	Nominations due for Chair-Elect, Secretary, Treasurer, and 3 Elected Council Members
1	Publishing Deadline - Winter 2013 Issue of the *Texas Tax Lawyer*
19	COGS Call 9:00 am Call-in Information: Phone #: 1-866-203-7023 Code #: 713-651-5591
TBD	Property Tax Conference
3	Nominating Committee's Report due to Council
15	Peach New Media Contract (24/7 library) must receive 45 days' notice before May 31, 2014, or contract will automatically renew for an additional 1 year time period; notice must be given by **April 15, 2014**, to terminate
19	Article Deadline - Spring 2013 issue of the *Texas Tax Lawyer*
23	COGS Call 9:00 am Call-in Information: Phone #: 1-866-203-7023 Code #: 713-651-5591
26	10:30 a.m. – 12:30 p.m. Council Meeting Hosted by: Thompson & Knight, LLP (Bob Probasco) One Arts Plaza 1722 Routh Street, Suite 1500 Dallas, Texas 75201 214-969-1187 Call-in Information: Phone #: 1-866-548-4716 Password: 2223040 Elect Chair-Elect, Secretary, and Treasurer
9-11	ABA Section of Taxation 2013 May Meeting – Grand Hyatt, Washington, DC

21	COGS Call 9:00 am Call-in Information: Phone #: 1-866-203-7023 Code #: 713-651-5591
31	Peach New Media Contract (24/7 library) terminates on **May 31, 2014**; must give notice 45 days before this time period or contract automatically renews for an additional 1 year time period
6-7	29th Annual Texas Federal Tax Institute – Hyatt Regency Hill Country Resort, San Antonio
7	Publishing Deadline – Spring 2013 issue of the *Texas Tax Lawyer*

Back to Table of Contents

2012-2013 NOMINATING COMMITTEE

The following Tax Section members have been appointed to the 2012-2013 Nominating Committee:

- Daniel J. Micciche, Nominating Committee Chair
  Dallas, Texas

- Patrick O'Daniel
  Austin, Texas

- Mary A. McNulty
  Dallas, Texas

- Tina R. Green, Ex-Officio Member
  Texarkana, Texas

Any Tax Section member may submit nominations by March 1, 2013, to any member of the Nominating Committee for the offices of Chair-Elect, Secretary, Treasurer, and the three Elected Council members for the 2013-2014 bar year.

Back to Table of Contents

CALL FOR NOMINATIONS FOR
OUTSTANDING TEXAS TAX LAWYER AWARD

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

Nominations should be submitted to Tina R. Green, either by email (tgreen@capshawgreen.com) or fax (888-371-7863) no later than January 15, 2013. The award will be presented at the 2013 Annual Meeting of the Tax Section in Dallas on June 21, 2013.

NOMINATION FOR OUTSTANDING TEXAS TAX LAWYER AWARD

Nominee Name: ____

Mailing Address: ____

____

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

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

Back to Table of Contents

COMMITTEE SELECTION FORM 2012-2013
Section of Taxation
State Bar of Texas

NAME: ______________________________ DATE: ____________________

FIRM: ____

ADDRESS: ____

CITY STATE ZIP CODE

TELEPHONE NO: (_____)______________________ E-MAIL: ______________________

BAR CARD.: ______________________________

PLEASE CHECK THE BOX FOR EACH COMMITTEE YOU ARE INTERESTED IN JOINING:

	COMMITTEE	CHAIR
☐	**Corporate Tax**	Jeffry M. Blair Hunton & Williams LLP 1445 Ross Avenue, Suite 3700 Dallas, Texas 75202-2799 214-468-3306 214-468-3599 (fax) jblair@hunton.com
☐	**Employee Benefits**	Susan A. Wetzel Haynes & Boone 2323 Victory Ave., Ste. 700 Dallas, Texas 75219 214-651-5389 214-200-0675 (fax) susan.wetzel@haynesboone.com
☐	**Energy and Natural Resources Tax**	Shawn R. O'Brien Mayer Brown, LLP 700 Louisiana Street Suite 3400 Houston, Texas 77002-2730 713-238-3000 713-238-4888 (fax) sobrien@mayerbrown.com
☐	**Estate & Gift Tax**	Amanda M. Gyeszly Fizer, Beck, Webster, Bentley, Scroggins, PC 1330 Post Oak Blvd., Suite 2900 Houston, Texas 77056 713-840-7710 AGyeszly@FizerBeck.com

Back to Table of Contents

☐	**General Tax Issues**	David C. Cole Vinson & Elkins, LLP First City Tower 1001 Fannin Street, Suite 2500 Houston, Texas 77002-6760 713-758-2543 713-615-5043 (fax) dcole@velaw.com
☐	**International Tax**	Deidra Hubenak Looper Reed & McGraw, PC 1300 Post Oak Boulevard, Suite 2000 Houston, Texas 77056 713-986-7188 713-986-7100 (fax) dhubenak@lrmlaw.com
☐	**Partnership and Real Estate**	Dan G. Baucum Shackelford, Melton & McKinley, LLP 3333 Lee Parkway, Tenth Floor Dallas, Texas 75219 214-780-1470 214-889-9770 (fax) dbaucum@shacklaw.net
☐	**Property Tax**	Mary A. Van Kerrebrook Van Kerrebrook & Assoc., P.C. 1125 Lyric Centre 440 Louisiana Houston, Texas 77002 713-425-7150 713-425-7159 (fax) Mary@vkalawyers.com
☐	**Solo and Small Firm**	Catherine C. Scheid 4301 Yoakum Blvd. Houston, Texas 77006 713-840-1840 713-840-1820 (fax) ccs@scheidlaw.com
☐	**State and Local Tax**	Ira A. Lipstet DuBois, Bryant & Campbell, LLP 700 Lavaca, Suite 1300 Austin, Texas 78701 512-381-8040 512-457-8008 (fax) ilipstet@dbcllp.com

Back to Table of Contents

☐	**Tax Controversy**	David E. Colmenero Meadows, Collier, Reed, Cousins, Crouch & Ungerman, LLP 901 Main Street, Suite 3700 Dallas, Texas 75202 214-744-3700 214-747-3732 (fax)
☐	**Tax-Exempt Finance**	Peter D. Smith Fulbright & Jaworski, LLP 98 San Jacinto Blvd., Suite 1100 Austin, Texas 78701 512-536-3090 512-536-4598 (fax) pdsmith@fulbright.com
☐	**Tax-Exempt Organizations**	Terri Lynn Helge Texas Wesleyan School of Law Associate Professor of Law 1515 Commerce Street Fort Worth, Texas 76102-6509 817- 429-8050 thelge@law.txwes.edu

PLEASE COMPLETE THIS FORM AND FORWARD IT TO THE COMMITTEE CHAIR(S) FOR EACH COMMITTEE THAT YOU ARE INTERESTED IN JOINING.

Back to Table of Contents

State Bar of Texas
Tax Section

Annual Law Student Tax Paper Competition

Eligibility: J.D. and LL.M. law students attending Texas law schools

Awards*: First Place - $2,500 and plaque

Additional Awards for Second Place ($1,500) and

Third Place ($1,000) at Judges' Discretion

* See Competition Rules below for limitations on awards

Subject: Any federal or state tax topic

Entry Deadline: Friday, May 31, 2013

Competition Rules:

Eligible Students: All J.D. and LL.M. degree candidates attending accredited Texas law schools either on a part-time or a full-time basis at the time the paper is written.

Awards: First Place - $2,500 cash prize and plaque.

Additional cash prize of $1,500 for Second Place and $1,000 for Third Place may be made in the sole discretion of the judges if the number of entries and the quality of the papers merit additional awards.

If the judges determine that none of the papers submitted to the competition satisfy the standards for the competition, the judges have the discretion to determine that no prizes should be awarded for any of the papers submitted.

Paper Topic: Any federal or state tax topic (including topics relating to tax practice ethical and professional standards).

Back to Table of Contents

Eligible Papers:

a. Paper must be sponsored by a law school faculty member.

b. Only one paper per student.

c. Paper may be submitted for publication in law reviews or law journals, provided the version submitted to such publications does not reflect any changes made to the paper after submission of the manuscript to the Tax Section's Annual Law Student Tax Paper Competition. Paper may not be the work product of employment or an internship (*e.g.*, briefs, legal memoranda, opinion letters, etc.).

d. Paper must be written after May 31, 2012.

e. Paper may not be longer than fifty pages (on 8 ½ by 11 inch paper, double spaced, twelve point font, and one inch margins on all sides) including footnotes, endnotes, and exhibits, but not including any cover page, table of contents, or table of authorities. Footnotes and endnotes may be single spaced. Footnotes (rather than endnotes) are preferred, but not required.

f. Title of paper (or abbreviated title) must appear on each page of the paper and all attachments including endnotes, exhibits, cover page, table of contents, or table of authorities. A page number must appear on each page of the paper including endnotes and exhibits (to verify compliance with fifty page limitation in e. above). No page number is required on the cover page and the table of contents or table of authorities may be numbered for reference with a numbering scheme independent of that used for the paper.

Submission:

a. All entries must be received after January 15, 2013, and before Saturday, June 1, 2013.

b. All entries must be submitted electronically as attachments to an e-mail message sent to radzgery@fulbright.com and tgreen@capshawgreen.com with the subject line "LAW STUDENT TAX PAPER COMPETITION" (in all caps).

c. The e-mail must include the following documents:

i. Information Sheet prepared by the entrant in Adobe Acrobat pdf format with the following Information:

A. Title of the paper;

B. Student's Name, Law School and Class, Address, Phone Number, and E-Mail Address (please include current and summer contact information); and

C. Faculty Sponsor's Name, Address, Phone Number, and E-Mail Address.

ii Paper in Microsoft Word or other word processing format.

Back to Table of Contents

iii. Paper in Adobe Acrobat pdf format.

d. Paper must contain a title but should not contain any information which identifies the author, law school, or faculty sponsor.

e. Shortly after receipt of the submission a confirmation of receipt of the entry will be sent to the entrant and faculty sponsor by e-mail with the information sheet as an attachment.

Judging: Papers will be evaluated, and prizes awarded, at the sole discretion of a panel of Tax Section members who will have no knowledge of the authors, law schools, or sponsors of the papers. ***If the judges determine that none of the papers submitted to the competition satisfy the standards for the competition, the judges have the discretion to determine that no prizes should be awarded for any of the papers submitted.***

Evaluation Criteria without specific weighting:

a. legal analysis;

b. legal research;

c. organization and writing style; and

d. originality and relevance of topic to current tax matters.

Notification: Winners will be notified in July or August of 2013 and an e-mail will be sent to all entrants shortly after the winners are notified.

Publication in *The Texas Tax Lawyer*: The author retains all ownership rights with respect to his or her work submitted to the competition; however, all top entries will be considered for publication in *The Texas Tax Lawyer* and for posting on the Tax Section website.

Publicity: The name of each winning entrant and the entrant's sponsor will be listed on the Tax Section website and may be included in e-mails sent by the Tax Section to Section Members.

Questions: Any questions regarding the competition should be sent by e-mail to Ron Adzgery at radzgery@fulbright.com or Tina Green at tgreen@capshawgreen.com with the subject line "LAW STUDENT TAX PAPER COMPETITION" (in all caps).

Back to Table of Contents

INTERVIEW OF TEXAS TAX LEGEND CHARLES HALL
JUNE 15, 2012

Mary McNulty Bill Elliott has created such a great tradition at our annual meeting. He interviews a true Texas tax legend. Past interviews have included Buford Berry, Richard Freiling, Ron Meinkoff, Bob Davis and former IRS Commissioner Larry Gibbs. It's something I really look forward to each year and I think you will really enjoy it. Bill spends hours preparing for these interviews and they really are quite fascinating. If you have missed past interviews we now have them posted on the tax section website and you can download them and review them at your leisure. This year Bill will be interviewing Charlie Hall of Fulbright & Jaworski and Bill I understand that you've already began preparing for next year's interview of Emily Parker who was this year's outstanding Texas Tax Lawyer. So before we get started with Bill's interview of Charlie, I would like to ask Jack Allender to come up and make an award presentation.

Jack Allender Thank you. This will take just a few minutes; I'm taking part of this important time. I've worked with Charlie for 36 years and he's such an outstanding lawyer. He's worked over that period of time to really build our tax litigation practice in our firm, and this year, without really any effort from Fulbright at all, we found out we were named the top tax litigation firm in the country by U.S. News and World Report and I just wanted to make a presentation to Charlie and thank him.

Charlie this is for you to hang on your wall; Fulbright & Jaworski has been selected as U.S. News Best Lawyer's Law Firm of the Year in Tax Litigation. Congratulations. It's all yours.

Bill Elliott If you want to know what a privilege is, this is it. The chance to talk to Charlie Hall and question him at length about his career is an extraordinary thing and I'm privileged to be able to do it. The full interview is on the website. I've never seen so many ex-chairmen of the State Bar Tax Section as we have had today; they're just pouring into the room right and left and that's tribute to our guest. In the interest of time we going to go to 1:15 sharp and between 1:15 and 1:30 if anyone has any question of Charlie Hall you'll have a chance to ask him. Gibson Gayle has already said that he's not sure he can restrain himself. So we'll see what Mr. Gayle does between 1:15 and 1:30.

But anyway, Charlie Hall is a native of Dallas, Texas; went to Highland Park High School, Sewanee University, SMU Law School and his father was a lawyer. He worked for three years at Storey, Armstrong and Steger in Dallas as a general lawyer, met a woman who became his wife, and felt the magnetism of Houston because that's where she was. Hugh Steger put in a call to Leon Jaworski and Kraft Eidman and said you need to hire this guy, and so Charlie moved to Houston, did some sort of interview with the big guns at Fulbright (at the time on a Saturday morning) and they hired him. 55 years he's been practicing tax law and he's at the preeminence of his profession. He and Vester, of course, are at the deans of the Texas Tax Bar. His case list is extraordinary. 80 cases, give or take, on the Westlaw list. Circuit Courts of Appeal occupy about 40% of those cases; about 60% are court of claims or U.S. District Court. There's a big gap in Tax Court we'll talk about, but he finally got warmed up to the Tax Court later in life, but it was missing in his docket for a long time and we'll talk about that. To read the case list, it looks like the honor roll of the United States Chamber of Commerce. Coca-Cola, Shell, Texaco, on and on and on; it's just unbelievable. Big cases representing big economic interests. It's quite the accomplishment to imagine the creation of a tax practice amidst the competitive situation of the Houston law firms, so it's quite extraordinary.

Bill Elliott — Charlie, you're 81 years old.

Charles Hall — Yes, sir.

Bill Elliott — You're enthusiasm for being a tax lawyer, doing your thing, seems unabated. What is, you think, your assessment of how your enthusiasm has sustained itself even to today?

Charles Hall — It's pretty simple; I like doing what I'm doing.

Bill Elliott — Somewhere along the way the law grabbed ahold of you and it just hasn't let go and I have not seen any diminution in your enthusiasm for being a lawyer doing your job everyday uninterrupted by anything else. Am I missing something or would you say you have had a pretty consistent path in terms of enthusiasm, commitment and such?

Charles Hall — Well, right now my wife's in the hospital and so there's a little less enthusiasm, but, other than that, it's what I do.

Bill Elliott — When you first arrived at Fulbright, I guess 1958?

Charles Hall — 1957.

Bill Elliott — What was the tax department composed of?

Charles Hall — There was Bill Wellen, a fellow named Clarence Kendall. I think I was number three, and Clarence Kendall was doing his own thing on the side.

Bill Elliott — How did you perceive Fulbright in relation to the other two firms at that time when you entered the Houston practice?

Charles Hall — I was totally naïve; I had no understanding of any Houston firm. I just came down here on the spur of the moment. I had met Gibson once years before, and the Storey, Armstrong and Steger firm called the people down here, Kraft Eidman included, and said you ought to interview him. So instead of coming down to see Mary Lou, whom I was courting, on Friday evening, I came and interviewed all day Friday and Saturday morning and they offered me a job the next Tuesday, and I moved.

Bill Elliott — How did the cases get staffed on your first, say month of working; what was on your desk when you arrived; what kind of work was on your desk?

Charles Hall — Chase, what was then Chase Manhattan Bank, JPMorgan Chase had a gigantic estate and gift tax case for the individual who was deceased who had run Conoco, Continental Oil, and it had been tried in the Tax Court and partially won and partially lost. It involved community property so the New York people decided they'd get a Texas firm to appeal it to the Fifth Circuit on community property and other items, and I was the gopher for that case. I drafted the briefs for Bill Wellen and Malcolm McCorquodale who was a senior trial lawyer.

Bill Elliott — Now as I understand it you were simultaneously pursuing your LL.M.; you hadn't graduated?

Charles Hall — I had finished my course work; so the law firm said – I had wanted to be corporate securities lawyer – but the law firm said we don't really need one of those right now but we can use a tax lawyer and it you want to draft the briefs in this Chase Manhattan case maybe you can turn that into your thesis. So I got up every morning at 4:00; worked at the law firm from 4:30 to 8:30 on my thesis and then went to work on the law firm work.

Bill Elliott — Of course that case has proven to be an iconic decision, it's one of those fundamental cases you always look to in terms of taxation of life insurance in a community property context. Did it feel important to you at the time?

Charles Hall — Well, it was enormous to me. I hadn't done anything like that in Dallas and it was fun and it was what I egotistically called the big time.

Bill Elliott — Well if you're representing the estate of the head of Conoco I'd say that's the big time.

Charles Hall — Yeah.

Bill Elliott — So what was the breakdown between Wellen and McCorquodale in terms of approaching the tax work?

Charles Hall — McCorquodale was a 60-plus year old experienced trial lawyer, jury trial lawyer. Bill Wellen was a Harvard MBA in tax and knew tax law back and

	forward; so they were a team, and I was their gopher, a person to do odd errands.
Bill Elliott	As the years went on, did you draw influence particularly from one or the other of them?
Charles Hall	I would say both, but McCorquodale was very practical-minded, he called himself a jaw-bone lawyer, and I had seen a lot of technical tax lawyers but I had not seen close-up any jaw-bone lawyers.
Bill Elliott	Did you work 5, 6 days a week? What was your work pattern when you first started?
Charles Hall	All the time.
Bill Elliott	Of course you were doing your LL.M. on the side so you just went all out. But was that normal, did you have office hours on Saturday?
Charles Hall	Oh yes. Back then we worked something like 9:00 to noon on every Saturday. Of course we worked on New Year's Eve and worked half a day on Christmas Eve.
Bill Elliott	Did you feel at the time that you had taken a job with a sweat shop, or did you feel it was a reasonably balanced life you were leading or did you regret oh my, I'm having to work too hard, what was your thinking about the work ethic?
Charles Hall	That was another part of my naivety, I never noticed. That's just the way things were.
Bill Elliott	What was it McCorquodale taught you about trying a tax case?
Charles Hall	Well, he didn't know anything about tax law and he said "look we've got this tax case; Charlie, find the fact issue." I guess I learned generally, and I really appreciate it, from him that 99% of tax cases are pure fact questions, of value, of intent, of motive, all kinds of things. Usually both sides know what the law is. Sometimes we argue about that over summary judgment; most of the time we're in pretty good agreement about the law; it's how you decide the facts.
Bill Elliott	Has that lesson stayed with you through the years? I've heard it said that's one of your core ways of approaching a case is the factual inquiry, jury argument first.
Charles Hall	Yes, or do the jury charge. That's what I've tried to accomplish with our new lawyers. They always were surprised. If we had a Tax Court case, I'd say draw the jury charge or the jury instruction. They said this is a Tax Court tax

	case – there is no jury; and I said, if you can figure out the issue in the case and you can give me the instructions, we can take it from there.
Bill Elliott	And you do that even today?
Charles Hall	Yes.
Bill Elliott	Now, McCorquodale died soon into your practice?
Charles Hall	June 15, 1958, excuse me December 15, 1958. He had a heart attack on a hunting trip with a big client, and I went home that night and said, "Mary Lou, we're going to Dallas; there's no place for me here."
Bill Elliott	Because he was your main guy in terms of litigation?
Charles Hall	Yes.
Bill Elliott	So what happened?
Charles Hall	I don't know. I stayed.
Bill Elliott	Now you have described the cases involving the company Farnsworth & Chambers as being one of the determining things in your life. Can you describe that phenomenon?
Charles Hall	That was a triple Ph.D. in tax law for me. Trying to make it very brief, a man named Dunbar Chambers was one of the leading participants in a major construction firm, Farnsworth & Chambers. It built the Air Force Academy, built things all over the country. The people from that company have formed half the big construction companies in this town. Anyway, Mr. Chambers went to North or South Dakota with some friends from Houston, he was killed in a hunting accident, and everybody in the group swore silence. It was an accident, and nobody was going to say who pulled the trigger. And so he died and there was a funeral. Then the IRS came in and accused some of the remaining executives of that company of criminal tax fraud. They set up an estate and gift tax deficiency against Mr. Chambers' estate, and they started about 90 income tax cases against Farnsworth & Chambers Company and various subsidiaries. So McCorquodale was in charge of that, Bill Wellen was the tax brains, and I was the gopher. McCorquodale died 18 months into it and all of a sudden I had more work than I could ever deal with. We went to the Fifth Circuit five times, the criminal case went to the Supreme Court twice, and we went to the district court, the court of claims, and the Tax Court, and finally to get the whole thing settled, we had bi-weekly meetings among IRS Appeals, Department of Justice, Chief Counsel's Office, and me, and we would have an agenda of issues to settle. "Next week we'll talk about issues 95 through 97," and that went on and on and we finally got rid of the whole case.

Bill Elliott	Roughly, you were about a four or five year lawyer, if you think about how long you had been out of law school, two years at Storey Armstrong, say a year and a half or two years at Fulbright, so you were pretty youthful, but after McCorquodale's death, did the firm what looked to you?
Charles Hall	No, they looked to Bill Wellen, but I'd gotten more and more of a role in interviewing witnesses and doing it. Eleven years later I wound up as the partner-in-charge of the case, and the ironic thing that happened was we had the whole thing settled, we had refund checks issued, and I got a call from Dunbar Chambers, Jr., saying "the IRS is out here, they are claiming at the company that all the interest income from the tax refunds has caused us to be a personal holding company and they're starting all over again." We got in the books pretty quickly and found out that interest on a government refund is not personal holding company income.
Bill Elliott	So did you have anybody to help you?
Charles Hall	We started hiring people after that. Don McDonald came in, and he was doing employee plans and other things, Bill Ryan came in and then a series of other people, Phil Mann, Ken Gideon, and Jack Allender.
Bill Elliott	What was the venue law back then with respect to tax refund cases?
Charles Hall	Well a taxpayer, instead of having to sue the United States if he paid his tax and wanted to go to court, could sue the District Director of the Internal Revenue where he lived. At that time Houston was in the Austin District. So Mr. R. L. Phinney was the District Director and we filed income tax refund and other federal refund suits against Mr. Phinney in Austin.
Bill Elliott	On your docket sheet from Westlaw, it shows a 1959 tax court case and there's not another one until 1971. So, I'm sure maybe you settled them but in terms of decided cases there weren't any tax cases. Is that because you just preferred the venue of District Court so willingly?
Charles Hall	We found out that the juries in Austin, Texas were pretty favorable. So we started filing refund cases and asking for a jury trial, and that turned out to be a good plan.
Bill Elliott	Now there was no tax division of the Department of Justice in Dallas so the Department's lawyers what came from Washington?
Charles Hall	They'd fly down for the cases and prepare them as best they could, and basically we hometowned them.
Bill Elliott	Well, this is kind of a delicate question but culturally I'd say you present a different image in an Austin courtroom in front of an Austin jury to a Justice Department lawyer from the East Coast. Would that be a fair statement?

Charles Hall	That's possible.
Bill Elliott	Did you feel embarrassed that you were taking advantage of these poor souls?
Charles Hall	It was justice.
Bill Elliott	Alright so, on your docket sheet there's Phinney, Phinney, Phinney, Phinney, you go down the list there's Phinneys, everywhere. Did you approach Austin cases with local counsel?
Charles Hall	Yes. We had McKay & Avery. Buck Avery was our trial counsel and jury selector, and there was hardly ever a jury panel on which he didn't know many of the members.
Bill Elliott	What was his connection to the nominal defendant, Mr. Phinney,?
Charles Hall	I was telling you that I was a little confused about it. I think that maybe he was his or Mr. McCorquodale's brother-in-law.
Bill Elliott	All right so, yes he was. So you hired the District Director's brother-in-law as your local counsel in Austin; that's really funny. You did it for years. I mean it wasn't just once, it was like years.
Charles Hall	Well, the government changed the venue statute on us.
Bill Elliott	All right so, Mr. Phinney was just the nominal plaintiff but his name was on the pleadings with respect to, he was the defendant, if you will. So did you take advantage of that in your jury presentations?
Charles Hall	I wouldn't say I took advantage of it, but we mentioned it. When I started trying the cases myself, instead of being the second chair, I remember one case in which the plaintiff was a white-haired widow; I made the jury argument that here is this wonderful woman you have heard sitting here and arrayed against her is the entire might of the United States of America – the Internal Revenue Service, the Treasury Department, the Army, the Navy, the whole bunch – and they don't have anybody in the courtroom. I found that that resonated the first time I tried it.
Bill Elliott	Sort of like where is Mr. Phinney?
Charles Hall	Where is Mr. Phinney? So I'd turn around and look in the courtroom and say "nobody here for the government oppressing this poor lady."
Bill Elliott	So did you continue that?
Charles Hall	Up to a point. I finally realized that I was riding that pretty hard, and I got up one time to make my argument and I looked around (Bob had become a

personal friend by then) and I saw him back there just smiling, so I changed the approach quickly.

Bill Elliott — Now a significant load of your cases were Courts of Appeals cases. I mean that's almost 40 almost 50% of the entire case list is Fifth Circuit, Third Circuit, D.C. Circuit and all the rest. How did you approach Circuit Court arguments, would you do that, would Wellen do that, how was that staffed out?

Charles Hall — We split it, but later on I started doing most of it.

Bill Elliott — Do you remember your first Fifth Circuit appearance?

Charles Hall — Yes. I don't remember the case. I remember the chief judge was Chief Judge Joe Hutcheson who was a classic, elderly, dominating, wonderful judge, and I stood up and said "may it please the court," and Chief Judge Hutcheson looked at me and said, "young man, we know what you're trying to do and I don't think this court is going to let you do it; now make your argument." And we lost.

Bill Elliott — Now the Court of Claims is present in your docket sheet even from the earliest days. What was your approach in thinking about the Court of Claims as opposed to the other venues? You've already said the Tax Court wasn't in your consciousness as favorable, but what about the Court of Claims?

Charles Hall — I don't want to get in trouble with a varied audience, diverse audience, I don't know what people may think, but we had the idea at the beginning that the Tax Court (I've forgotten how many judges, whether they had 19 then or not) was about 99% ex-government people rewarded for long years of tax collecting, and we had a suspicion that it was easier to get a fact-finding on a tough fact dispute from somebody whose whole life was not motivated by – whole life wasn't directed at tax – from a generalist judge who might look at something and realize a taxpayer had a business motive as well as a tax motive. So for that reason, we didn't go the Tax Court very often, and so we decided we'd go – when we got kicked out of Austin, we decided we'd go to the Court of Claims.

Bill Elliott — When the venue statute was changed?

Charles Hall — Yes. And then they had commissioners. Mastin White was a Texan; his brother was a partner at Baker Botts, I think. He liked to come to Texas, and he was a good, fair, hard judge. So we started filing cases in the Court of Claims.

Bill Elliott — And you would get him almost most of the time?

Charles Hall — Usually we got him.

Bill Elliott	And did you find that venue, even in the early days of your practice, successful to you?
Charles Hall	It was successful, but it was slow and tedious, incredibly slow and tedious. And – I guess I'm looking out in the audience, and I hope I'm not getting in trouble – the head of the Court of Claims Division of the Department of Justice was an individual, I won't say what sex who had been there forever and was a little difficult to deal with in settlement. So several things existed. It worked out all right, but it wasn't ideal.
Bill Elliott	From a business development prospective, how would you assess your ability to generate legal business, tax business for the firm in light of your strategy about willing to take a case to trial, go the jury and actually go all the way. Did that result in business development?
Charles Hall	I don't know. I never thought I could develop business or work a room like some people can, I don't know when it happened, but some years ago people started calling me. I don't know what happened, I guess some things just came together, and they just started calling me.
Bill Elliott	Don't you think it had something to do with your willingness to go all the way and succeed in the courtroom, almost a trial lawyers perspective of taking it?
Charles Hall	I hope so. Some new clients said somebody had said we weren't afraid to pick a fight with the government.
Bill Elliott	But the irony is you're a very gentle soul and so this notion of picking a fight was in the context of tax litigation is a more civilized way of resolving disputes. Did you feel that the litigation was civilized?
Charles Hall	It was at first more than it is now. In the early days I think any trial lawyer in Houston will tell you that he used to know the other lawyers that he tried cases against. In the early days I knew all the Justice lawyers and the Chief Counsel lawyers. A lot of them were friends, a lot of their wives were friends. I've had dinner with couples; one local tax firm staffed with ex-Justice lawyers asked me to help them form the firm. Later we'd see one government lawyer and never see him again and sometimes it got pretty, what's the word, close to the line the way things were being done and certainly no intermingling much. That's not saying there wasn't any at all, but there was less.
Bill Elliott	How has that change affected your enthusiasm for tax work?
Charles Hall	It hasn't changed; that's just life.
Bill Elliott	So business development, you look down the list of the clients who have come your way and they're very substantial. Let's just take one that's very

prominent – Shell. You just don't find Shell standing on the street corner, I need a lawyer; have a sign up. So how would you have landed, just taking that as one example, the Shell account?

Charles Hall — There's at least one person from Shell in the audience. My version of the story is that one of our partners took a plane from Washington to Houston and sat next – Shell moved to Houston in the early 70s – to the Shell Vice President of Tax, and they exchanged cards. My friend, my partner, gave me the card and said you might want to meet this fellow; so I called him, and we had lunch. We had lunch a couple of times. Then he had a very small stamp tax case and said "you appeal this," and we appealed it, and we lost. Then one thing led to another. We were doing sensitive payment examinations, and we did a gigantic tax case, at the time one of the largest on the Tax Court docket if not the largest.

Bill Elliott — So the first case they gave you wasn't necessarily a quality piece of business in one sense but what lessons did you learn with respect to entree opportunities like that?

Charles Hall — What I learned was anytime you can get a small opportunity for a new client give it everything, you never can tell what can come from that.

Bill Elliott — Did you do the traditional speaking to bar groups and lecturing here and there, was that part of your MO? Has it been over the years?

Charles Hall — Yes, I was invited a number of times to give speeches, and I did that and got active in the bar associations.

Bill Elliott — Did you think that those activities helped you on business development?

Charles Hall — Yes and no. I think there is a confluence of all these things. I found out several times when people called with work that they said, "oh, I saw you're on the Commissioners' Advisory Group, oh I read your article on geological and geophysical costs" and that paired with something else. Maybe they found out three things about me and two things about somebody else from all that background.

Bill Elliott — Charles, you've produced a lot of legal business over the years, a lot. Do you think that's the key is just working all these different avenues as best you can and trying see that they're mutually reinforcing, is that the message?

Charles Hall — Yes, and I guess just working very hard and thoroughly. There is no substitute for hard work and thoroughness and getting to the bottom of everything – over-preparing.

Bill Elliott — After the venue statute changed, therefore you're there in Houston District Court, did you feel comfortable and successful in Houston District Court for refund cases?

Charles Hall	Yes, we had some success there, and so much of the practice after that started being around the country. Sometimes I felt like an orphan in Houston and more at home in Atlanta or Los Angeles or Chicago or Minneapolis.
Bill Elliott	You see a lot of venues that start creeping on your docket list from around the country; I guess Coca-Cola would be an example of Atlanta-based cases and then all around. Was that easy on you to handle cases in other parts of the United States, did that affect the burden you were under?
Charles Hall	It just created a whole lot of travel, and that was no fun. There was a time I would be making 50 trips a year; a lot of them were overnight, but that's a lot of travel. So in retirement, I don't look forward to traveling.
Bill Elliott	Indeed. Your client base has been predominately big economic interests whether it's large corporations or very large if not billionaire kind of families and entrepreneurs. What is it like to represent people like that?
Charles Hall	That's a hard question; its stimulating, its ego building. Sometimes it's a little bureaucratic to compare a General Motors with an EDS or a very wealthy individual as far as making decisions and not going through the bureaucracy.
Bill Elliott	You've described, just to use that example, having worked for Mr. Perot and EDS during their early years as opposed to the General Motors decision making, could you describe the relative process for getting an outcome decision?
Charles Hall	That happened right after Mr. Perot left EDS and right after he was on the cover of Fortune Magazine saying GM has got it all wrong. I was going back and forth between Detroit and Dallas. When I had to get a decision made in the automobile company, the chief tax officer talked to the assistant controller who talked to the controller, who talked to the assistant vice president finance, who talked to the vice president of finance and sometimes talked to the board member. When we were at EDS I talked to the head tax officer and I'd say do we do this or that and he'd say "let's call Les;" Les was the chairman of the board. He'd say "Les, Charlie is here, can we ask you a question." We went around the hall, and Les would say black or white and we'd do it.
Bill Elliott	A little different contrast.
Charles Hall	It was quite a contrast.
Bill Elliott	Now I think one thing you and Mr. Perot might have in common is your barber.
Charles Hall	And the ears.

Bill Elliott So can you tell the story of coming out of the EDS office on Forest Lane?

Charles Hall Oh yeah, I've just been mistaken for two celebrities. When the EDS was on Forest Lane they ordered a cab for me to go to Love Field. I got in the back of the cab, and the cab driver said, "Mr. Hall," and I said, "yes." He said "hop in." We started off to get on whatever that street is toward Love Field, and he turned around, and he said, "are you traveling incognito, Mr. Perot?"

Bill Elliott Well did you disappoint him or did you just go with the flow?

Charles Hall I went along with it.

Bill Elliott It raises the question of how many times Perot has travelled incognito? Sort of, doesn't it? What about the billionaire entrepreneurs the big oil people that occupied your client lists and your friendships over the years? How do you assess representing those very independent-minded people in terms of giving them advice and having them follow your advice?

Charles Hall They are used to having their own way and having their own schedule and you're totally available – they're used to having the jet plane parked and ready, a driver ready, people scurrying around, so, when they call, its not to make an appointment, it's that "I want you here at 10:00 tomorrow morning," That could be in Los Angeles. So there is a difference.

Bill Elliott Is it pleasing and satisfying? I mean you're working on big cases.

Charles Hall Oh it's fun. It's interesting dealing with people like that.

Bill Elliott You tell the story of a woman who had her own sense of schedule in a courtroom, you want to repeat that story?

Charles Hall We were trying a case in the Court of Claims in New York City and our principal client who was female testified and testified well. She then was excused. She went by the counsel table, a small courtroom – Court of Claims has no jury. I don't know how they got this courtroom. She looked down at me and in a whisper you could hear at the far end of the court she said, "Charles, I have to get my hair done. Is it all right if I leave?" I said "get out of here."

Bill Elliott Kind of changed the tone of the testimony, didn't it? Did you see her later? Did she in fact get her hair done?

Charles Hall She did.

Bill Elliott Yeah, okay.

Charles Hall You don't know, but we tried another case for her in which she was showing off the family jewels. She married a – it was an expatriation case – she

	married a European nobleman, and she totally charmed the judge. She turned to him, and they had a private conversation in the middle of trial about each of the rings on her finger and how many hundreds of years old it was. The government lawyer was going crazy.
Bill Elliott	All extemporaneous?
Charles Hall	Yes.
Bill Elliott	It wasn't your engineering?
Charles Hall	No, the judge asked her about it. He asked what those jewels were.
Bill Elliott	The other side of representing some of these really wealthy interests is your friendships. I know Mr. Allbritton, for example, has become one of your life-long friends and that's a rewarding client relationship, personal relationship.
Charles Hall	Yes, he is a fascinating individual.
Bill Elliott	But you have done lots of work for him and his companies, Riggs National Bank and those kinds of things, Allbritton Foundation, but is it difficult to develop a personal relationship with these billionaires?
Charles Hall	I'd say yes and no. A number of our lawyers are attracted to work for them because they form a relationship, and I always say now remember you're not a part of the family, you're a hired gun, but leaving aside that aspect of it they're just people, they're just very successful, usually very smart people.
Bill Elliott	Have you ever been uncomfortable with the risk the clients are willing to take on? Sometimes these wealthy interests are more willing to throw the dice and you as a lawyer has to be more cognizant of risk. How has that presented itself in your practice?
Charles Hall	There have been awkward moments when you have had to tell them no.
Bill Elliott	Have you ever been fired from a client that you had to say no to – as a result of you saying no?
Charles Hall	No, I once lost a client because he didn't believe my advice. That's another story. I was a young lawyer, and somebody came in and wanted to start a business in Houston. We went through the whole thing, and he asked about zoning laws. I said, "we don't have any," and the client left and I found out a few weeks later that he had gone over to Baker Botts and said, "I got hooked up with some young lawyer over there and he doesn't even know the Houston zoning laws." So we lost him.
Bill Elliott	Maybe that was a good thing.

Charles Hall — Yes.

Bill Elliott — Let's talk about your interests in the American Bar. You're one of the few Texans who have chaired the ABA Tax Section. How did you first become active in the American Bar Tax Section?

Charles Hall — Years and years ago when we were trying those jury cases in Austin, there was scholarly and academic literature and talk about having one unified court for tax, one tax court to try the case and one tax court of appeals. We decided we would counterattack and suggest that the federal law ought to be changed so that you could go into any of the three courts without paying the tax or with paying the tax, concurrent jurisdiction among the three courts. So I wrote up a bunch of statutes and went to a meeting. One thing led into another, and I was active.

Bill Elliott — Well, that created a certain excitement.

Charles Hall — Oh yes, we had some interesting debates over that.

Bill Elliott — Did you pursue a certain path through the ABA leadership that led to your being chair?

Charles Hall — Well, the usual is you work in a committee, chair a committee maybe chair another committee, and perhaps get elected to the governing council, and then possibly an officer, and I just went up that path.

Bill Elliott — What was your thinking or attitude about bar work at that point in your life?

Charles Hall — That it was very important if you keep it in balance, that Bar work is not everything but it is an important part of being a lawyer.

Bill Elliott — You've described working for Mr. Storey in your first two years who, of course, was chairman of the ABA. How did his approach to Bar work impress upon you?

Charles Hall — Well that was a small group of lawyers. I've forgotten there were six, seven, or eight of us, and that was one of the nicest group of people I have ever worked with, just nice good friends. They were totally dedicated to Bar work to the point that sometimes I thought we gave it too much importance. That made an impression on me that that wasn't everything in life, and so it kind of made me want to keep in balance. Before I became Chair of the ABA Tax Section, I remember calling around asking previous Chairs how many hours they had spent on it because they kind of drafted me. The fellow they wanted to be Chair of the Tax Section couldn't do it, and they turned to me and said you have to do it and I said "whoa, wait a minute, I'm not sure I want to do it."

Bill Elliott — Were you reluctant generally to be Chair of the Tax Section? A lot of people view it as an ambition.

Charles Hall — Well, I wanted to do it, but I didn't know that I had time for it.

Bill Elliott — One of the themes in your life is you take care of business and your focus is your legal work that just comes through loud and clear, and you don't entertain distraction very easily.

Charles Hall — My daughter is staring at me on that question; I gotta be careful.

Bill Elliott — But would you say that's a fair statement? I don't mean it to the point of subordinating family and the rest, but I'm saying that a lot of lawyers do get occupied with Bar work and maybe politics or commercial interests or inner business?

Charles Hall — I think clients want you to represent them and represent them fulltime and overtime and double time.

Bill Elliott — So how did it finally come to pass that you accepted the ABA assignment as Chair?

Charles Hall — Well, it really happened this way. I had been vice chairman some years before and was out of the loop and thought I was out for good. Then a good friend of mine from Philadelphia was slated to be chair, and he said "I don't think I can do it either." Then the powers that be came to me and said "we're going to nominate you" and I said "let me think about it." And then one of those fellows, a friend at Sullivan & Cromwell in New York took me to dinner in New York and said, "Charlie, _____."

Bill Elliott — You got to do something?

Charles Hall — Yes. You've got to do something or get off the pot. So I said let's do it.

Bill Elliott — So you were the chair 87 or 88?

Charles Hall — About then.

Bill Elliott — Right on the heels of the 86 Reform Act

Charles Hall — Yes.

Bill Elliott — Which, of course, the ABA is always active in shaping how the law is interpreted. Did you feel a particular burden during your year resulting from the 86 Act?

Charles Hall — Yes, we had to do a whole lot of commentary and testimony on the 86 Act. It was interesting, I got to meet Dan Rostenkowski and spend some time with him. So some of it was interesting, but some of it was a burden.

Bill Elliott — Did you suffer through it as well as you could? I mean I'm sensing a certain reluctance.

Charles Hall — As another Washington lawyer once held the job said, "the best job in the Bar Association is to be past Chair of the Tax Section."

Bill Elliott — So when I saw you in San Diego you seemed pretty happy as a past chair this past January. So you still go to the meetings and participate?

Charles Hall — I still go so some of them, yes.

Bill Elliott — Y'all have special privileges as past chair that we don't know about?

Charles Hall — I get a red badge; that's the only privilege that I know of.

Bill Elliott — Another activity you've engaged in over the years is the national, the national I guess it's the CPA Lawyers.

Charles Hall — The National Conference of Lawyers and CPAs.

Bill Elliott — Can you tell us how that came to pass?

Charles Hall — Yes. First, that's an organization, which at that time had 7 lawyers from around the country and 7 CPAs, maybe 4 of them from the big 4 and 3 from other firms. It came about years ago when the lawyers felt that the accountants were practicing law, engaged in the unauthorized practice of law. So Randy Thrower, a friend in Atlanta and a former Commissioner of Internal Revenue, created a white paper, kind of a treaty between the two professions. So, when I came along and I was co-chair of it, that was all in turmoil, and we were negotiating what could be done. The lawyers were concerned that the accountants were going to court, the big accounting firms were going to court. The accounting firms said you lawyers can't handle it all which was true, and it was just a situation. It all went away when the SEC created these conflict rules, you can't audit and handle a tax controversy too. But it was an interesting interplay and debate, very scholarly and high level-debate, between top lawyers and top accountants about what their respective roles ought to be.

Bill Elliott — Did you feel that your leadership of that committee proved beneficial generally? Did you feel successful at your effort?

Charles Hall — No, it was almost impossible to reach an agreement, but I very much enjoyed the experience.

Bill Elliott — What about your ABA activity as influencing your friendships? You've spoken, as have many people, about your friendships over the years arising from ABA Tax Section?

Charles Hall — Mary Lou and I have made a number of very close friends. I think particularly of three couples, one from Philadelphia, one from Washington and one from New York, and we made a point of getting together at every meeting and having dinner and then that broadened into having trips together. That's just one example; there were a lot of good friendships made. In fact if I have a good friend in Houston, I may see him once a year, but I saw those people three or four times a year without fail.

Bill Elliott — You said earlier when we were talking about Mr. Perot and the cab ride outside EDS that you have been confused for famous people. Who else might you have you been confused with? You don't have the common visage.

Charles Hall — One time in the Dallas airport when the Baltimore Colts were in town, some kid came running up to me and said, "Mr. Unitas can I have your autograph." So I signed, or, I don't know what I did.

Bill Elliott — You told the story of you and Earl Campbell were having a meeting and a similar experience occurred, you want to tell that story?

Charles Hall — He was such in the public eye that the accountants took us over to a darkened part of a restaurant, and halfway through the meal two teenagers came running over and said oh may we have your autograph. He had a briefcase of 8x10s. He pulled out a couple, and they went back to their table. And pretty soon they came running back, and said, "our parents say that we asked for the wrong autograph. They said Baltimore/New York 1958, greatest game ever played."

Bill Elliott — So you signed Johnny Unitas again?

Charles Hall — I don't know what I did.

Bill Elliott — Okay. Honestly of all the things you have said to me in all the time we've been together, you being confused with anybody else on earth is the most astonishing fact. Of all your cases that you've handled, there's 80 on the case list much less the ones that never made it to the case list, would you have a singular disappointment, a case about which you say gee we shouldn't have lost that one?

Charles Hall — I tried a jury case north of Atlanta and lost it, and that was a big disappointment. Gus Blackshear is in the audience.

Bill Elliott — Is that Hall Paving?

Charles Hall — Yes. No relation, just happened to be Hall County, Georgia. Gus always said we won it on summary judgment, it went to the Fifth Circuit, and we lost. He always said he won it and then I lost it when we went back and had a jury trial. I'm trying to remember if Gerald Haddock, who I think came in afterwards, could be blamed.

Bill Elliott — Okay let's do that. There hasn't been enough blame thrown on Gerald Haddock, we need to do with, I guess, post-acquisition gains, offsetting losses something like that; gains and losses before and after an acquisition?

Charles Hall — Yes, bowling alleys.

Bill Elliott — You were surprised when I told you that NYU Professor Eustice used to talk about that case at some length and he had a great interest in that outcome so academic interest in it continued whether or not you screwed it up or not.

Charles Hall — That's been interesting because - - -

Bill Elliott — But you felt disappointed, disappointment about that, you felt like maybe you should have won that case? Um, that's interesting.

Charles Hall — You don't handle many cases without losing a bunch.

Bill Elliott — Of course, one phenomenon of your entire career has been the complexity of tax law, but thinking about the big arc for a minute, what is your perception of how tax practice has changed from when you started at Fulbright to now?

Charles Hall — Well, two things, first and maybe less important, is the impersonality of dealing with government officials. You can't buy them a coke and that sort of thing. But the other thing is that the law is just so unbelievably complex. We used to try cases on some simple issue, "was the gift made in contemplation of death," or, "what is the value of Black Acre," or something else like that. Now we try cases depending on section x which relates to the definition in section y which depends upon section z, and it's just a lot more complicated. The cases that go to court often have gigantic deficiencies which means everybody is geared up. The government now has big budgets for experts, budgets for depositions, they wind up taking 50 depositions in a case.

Bill Elliott — The case that's on your list that's most recent is involving the pharmaceutical, Merck.

Charles Hall — Yes.

Bill Elliott — The Third Circuit case was decided recently, and again you're in your retirement year so to speak. We'll talk about that in a minute, but here you're handling a $500 million tax refund case for Merck and 50 witnesses and it's

Back to Table of Contents

on the Third Circuit appeal, that doesn't seem like retirement to me. I mean I'm not sure, if that's retirement, Lord help us when you're working full time.

Charles Hall — Things have calmed down a lot in the last few years.

Bill Elliott — Okay. But would that be an example, it must be a complicated case?

Charles Hall — Yes.

Bill Elliott — You had 50 witnesses, something like that?

Charles Hall — I don't know how many, maybe 25 witnesses in the courthouse, but we must have taken 50 depositions. I've lost count.

Bill Elliott — But your case list has foreign tax credit, it has international oil and gas issues, you have substantial credits, I mean you have windfall tax occupied your time for a great amount of time. Those are complicated subjects.

Charles Hall — Yes, they are.

Bill Elliott — Do you find intellectually attraction to these mind-bending kind of issues?

Charles Hall — Yes and no. I mean it's frustrating that the tax law has to be that way, I just don't give it much thought.

Bill Elliott — Have you seen over the years a difference in how witnesses respond to questions? Are witnesses better than they used to be, lesser than they used to be? What's the quality of your witnesses?

Charles Hall — I think people are people, and you can always be surprised no matter how carefully you prepare them. When they hold up their hand and take the oath, anything is apt to happen.

Bill Elliott — So you experienced surprises from your witnesses?

Charles Hall — Many surprises. And, in spite of extraordinarily, I don't mean to be egotistical, good preparation. I had one expert out of Chicago say we've never been prepared the way you prepared us. But I'm talking about primarily fact witnesses.

Bill Elliott — Somehow they just change their outlook?

Charles Hall — Or they don't have the courage to stand up under intense or hostile questioning.

Bill Elliott — I guess that's one of the sides of tax litigation practice that maybe we don't hear so much about, the unexpected, the twists, the blows you take in the courtroom and how you handle it. What's been your experience, you've been at Fulbright all these years, and it's a big law firm, one of the tops in the country. Has it been satisfactory to you in terms of personal relationships? Has the big firm life weighed on your mind any? Have you ever thought about the Storey Armstrong world of six lawyers?

Charles Hall I found the two just the same. In the big firm I had squadrons of people who could help, and in the small firm there were fewer people I could reach out to – staff and lawyers, but other than that, they are all about the same. Most lawyers are just lawyers practicing law in their offices.

Bill Elliott Have you been tempted to be involved in firm management or maybe you've been involved in firm management?

Charles Hall I've had that pleasure.

Bill Elliott You're the one who likes to practice law and go to the office and do your work. So, how did you get talked into doing the firm management thing? What would be an example of some things you've worked on?

Charles Hall Well, I was in charge of our employment; I was in charge of our long-range planning committee when we reorganized the firm and Gibson Gayle was first elected. Later at one point before that Leon Jaworski came in and said I'm redoing firm management, I don't know what happened; I was young, but he said "we're going to redo this, we're going to form an executive committee," and he put me on it to my surprise at a fairly early age. So I just got involved.

Bill Elliott Of course Leon Jaworski is an iconic figure in his own right for lots of reasons, not the least of which is Watergate, but what was your take on him?

Charles Hall He was an incredibly interesting person. I have a couple of takes on him. One take is that he had incredibly quick good judgment – size up things and make a street-smart decision. Another thing was that I was just in the courtroom with him once. There were a bunch of lawyers; it was in Austin. He just made a trial-ready announcement but took over the courtroom when he did it. I was kind of surprised. I was used to bowing and scraping to a federal judge, and he just took it over. So I could see in that instance how he influenced or impressed people when he was around.

Bill Elliott Of course he entered the public sector a lot in different Watergate prosecutor among various things. Did you think the firm benefitted from his public

Charles Hall Oh yes, I would say that catapulted us into prominence because there was a time there when he was clearly the most, for a short period, he was clearly the most visible lawyer in the United States of America. When he finished Watergate he was on the cover of every periodical in this country and probably most of them internationally. So yes, suddenly he was a known quantity.

Bill Elliott	Again, I gather he could produce legal business too, just like you?
Charles Hall	Oh boy, that came from all over.
Bill Elliott	Would you practice tax law again if you were starting over?
Charles Hall	I have no idea. I stumbled into it and I wouldn't know what else to do now.
Bill Elliott	But intellectually, it's kept you interested?
Charles Hall	Intellectually, it's stimulating, overpowering.
Bill Elliott	I gather its satisfactory to you?
Charles Hall	Yes, sir. Quite satisfactory. I don't have many regrets.
Bill Elliott	On the work/life balance, of course you project a work ethic as one of your core character traits but how you size up in looking back your work/life balance working at Fulbright with the demanding schedule you've had and all the rest?
Charles Hall	I probably worked too much.
Bill Elliott	But you've not been a 7-day a week lawyer have you? Would you work on Sunday afternoon as a routine item?
Charles Hall	I used to routinely work on Saturday, but tried not to on Sunday.
Bill Elliott	Charlie, it's been a real pleasure. Thank you very much.
Charles Hall	Thank you.

Back to Table of Contents

AN INTRODUCTION TO

TARGET ALLOCATIONS

By: Dan G. Baucum[1]

I. INTRODUCTION.

"It is increasingly common for partnerships to use target allocations and not to liquidate in accordance with positive capital account balances."[2]

Tax professionals who review modern partnership or limited liability company agreements are likely to encounter target allocations as an alternative method for allocating a partnership's items of income and loss among its partners.[3] One sign that an agreement may contain target allocations is that the partnership does not liquidate in accordance with positive capital account balances. Liquidation proceeds follow the cash-driven distribution priorities contained in the distribution waterfall. Investors and business people view these cash-driven distributions as a straight forward, understandable method that forces partnership distributions to end up in the intended partners' hands. Whereas regulatory allocations can distort where liquidation distributions end up because of complex capital account maintenance rules and the regulatory requirement that liquidating distributions follow positive capital account balances.

My goal is to help you understand the difference between target and regulatory allocations; and how to spot when target allocations are being used. I do not wish to persuade you that one approach is superior to the other because both approaches have reasons to recommend them.[4] Furthermore, this is not a full treatment of the several methodologies followed and generally identified as "target allocations." A fuller explanation of target allocations is discussed in some of the papers cited in footnote two below.

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[1] Dallas, Texas. Chair, Partnership and Real Estate Tax Committee, Tax Section, State Bar of Texas.

[2] New York State Bar Association Tax Section Report on Partnership Target Allocations, September 23, 2010, p. 2 ("NYSBA's Report"). This paper borrows liberally from the NYSBA's Report; William G. Cavanagh, "Targeted Allocations Hit the Spot," Special Report, Tax Notes (October 4, 2010); and Donald E. Rocap, "Understanding Partnership Target Capital Accounts," Practical Law Company, April 1, 2011. Also consulted were two articles questioning the use of target allocations in some situations by Terence Floyd Cuff, "Working with Target Allocations—Idiot-Proof or Drafting for Idiots?" and "Working with Target Allocations—Drafting in Wonderland," Journal of Real Estate Taxation, Vol. 35, No. 3 and No.4 Second and Third Quarter 2008. To these experienced partnership tax practitioners I am most grateful. Any mistakes are my own.

[3] References to partnerships or partnership agreements include limited liability companies taxed as partnerships and their company agreements.

[4] For example regulatory allocations are required to avoid an adverse tax result. *See* I.R.C. §514(c)(9)(E)(the "Fractions Rule"). Until the Treasury Department issues guidance that a target allocation approach satisfies the Fractions Rule the regulatory approach is the only method available to avoid unrelated business taxable income by a tax-exempt partner in a partnership containing real property acquired or improved with indebtedness.

II. THE ALLOCATION REGULATIONS.

Partnership allocations are governed by regulations under section 704(b) of the Internal Revenue Code.[5] These regulations were drafted with an eye toward preventing abusive loss allocations stemming from the 1970's tax shelter boom, where taxpayers were allocated deductions without their economic consequences. To prevent this, the allocation regulations require liquidating cash or property distributions to match previously allocated profits tracked through the use of partner capital accounts.

For allocations to be respected they must satisfy the "economic effect" test, which is one part of "substantial economic effect." [6] To satisfy "economic effect," partners must (1) properly maintain capital accounts; (2) distribute liquidating distributions in accordance with their positive capital account balances; and (3) bring to zero any negative capital account balance through cash contributions or an allocation of income.[7] If an agreement complies with these rules its allocations will be respected.[8]

Most agreements, however, do not contain the third part of the economic effect test: a deficit restoration obligation requiring partners to restore negative capital accounts to zero.[9] These partnerships seek to satisfy the "alternate test for economic effect," which includes maintaining capital accounts and following liquidation rules, but also requires the partnership to include a "qualified income offset."[10] More importantly, this alternate test for economic effect requires that partner losses are limited to their positive capital account balances, which must be reduced by reasonably anticipated distributions, losses, and depletion. This can and often does cause capital account balances to fall out of sync with partners' ownership percentages, causing concern that upon liquidation one or more partners will end up with fewer distributions then they are entitled to.

III. CAPITAL ACCOUNT MAINTENANCE AND BOOK INCOME.

For the economic effect test or the alternative test for economic effect to work capital accounts must be maintained. Generally, each partner has a capital account to which is added cash or the fair market value of property contributed to the partnership, along with allocations to that partner of income or gain (*i.e.*, profits). Subtracted from a partner's capital account balance is any cash

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[5] Treas. Regs. §§ 1.704-1 and -2.

[6] Treas. Reg. § 1.704-1(b)(2)(ii). The substantiality test is not discussed.

[7] Treas. Reg. § 1.704-1(b) *et seq. See, generally,* McKee, Nelson & Whitmire, Federal Taxation of Partnerships and Partners (WG&L) and Willis & Postlewaite, Partnership Taxation (WG&L).

[8] Allocations of deductions attributable to nonrecourse liabilities cannot have economic effect. They are "deemed" to be in accordance with the "partners interest in the partnership" and thus to have economic effect. *See* Treas. Reg. §1.704-1(b)(3), Treas. Regs. § 1.704-1(b)(4) and §1.704-2.

[9] This discussion of partnership taxation also applies to limited liability companies taxed as partnerships for federal tax purposes.

[10] Treas. Reg. §1.704(b)(2)(ii)(d). This test is sometimes referred to as the "economic effect equivalence test." A Qualified Income Offset (or "QIO") is one of the boilerplate tax rules contained in agreements.

or the fair market value of property distributed to that partner and any expenses, losses or deductions allocated to that partner. The partner's positive capital account balance reflects his or her ownership interest in the partnership; but the balance is subject to adjustments as various partnership activities take place.

Capital accounts are adjusted by book income or loss, not taxable income or loss. Book income or loss is not the same as financial accounting income derived by applying Generally Accepted Accounting Principles (GAAP). Book income is derived from federal income tax principles, just like taxable income. The difference between book income and taxable income is that their calculations have different starting points. Book income starts with an asset's fair market value. Whereas taxable income starts with the asset's adjusted tax basis.

Partnership economics diverge between book income and taxable income in a number of situations requiring capital account adjustments. For example partnership economics change when a partner contributes appreciated or depreciated property to a partnership; when a partner receives a disproportionate distribution of appreciated of depreciated property from the partnership; when a partner receives a carried interest or a profits interest in the partnership; and when a new or existing partner makes a cash contribution that is not proportionate to partners' prior cash contributions to the partnership. In each of these instances the partners' capital accounts must be revalued to reflect the current fair market value of the partnership's assets in order to prevent an inadvertent shifting of value among partners.[11]

IV. ARE REGULATORY "SAFE HARBORS" REALLY SAFE?

If capital accounts are properly maintained and the other regulatory rules are followed one is justified in assuming that the IRS will respect your partnership allocations and you are safe should you be audited. Should, however, you worry whether the right partners get the right distributions upon liquidation of a partnership that is a harder question.

Partnership income is taxed on a flow-through basis to the partners whether or not cash is currently distributed. This requires partnerships utilizing regulatory allocations to determine two things to keep matters straight: (1) how income and loss is allocated among the partners (the "allocation waterfall"); and (2) how cash (and in some instances property) is distributed among the partners (the "distribution waterfall").

For a partnership with a very simple capital structure, the distribution and allocation waterfalls may be the same. For example, all cash is distributed and all income and losses are allocated in proportion to the partners' ownership percentage.

[11] *See* Treas. Reg. §1.704-1(b)(2(iv)(*f*).

But a partnership with a more complicated capital structure may have the distribution and allocation waterfalls diverge. When that takes place capital accounts may change the way partners receive liquidating distributions from the way they receive cash distribution during operations.

EXAMPLE ONE: A contributes $100 and B has no obligation to contribute any capital. A is to receive an additional amount of $10 per year until his capital contribution is returned. After A's capital and preferred return are paid each partner will share equally in partnership income and distributions. If in year one the partnership has $50 income and $50 cash in the bank that it intends to distribute, the $50 cash will go to A under the distribution waterfall.

Since A got the cash, is he allocated the $50 profit under the allocation waterfall? A's deal with B is that his capital contribution is to be returned first under the distribution waterfall. A's return of capital should be tax free under partnership tax rules. For this to happen B should pay tax on his share of partnership profits until A's capital is returned (without any offsetting cash distributions).

But A should pay tax on $10 of the year one $50 income that he receives as a preferred return. This leaves $40 of income to be allocated. Should A or B pay the tax on the remaining $40 of income? If A pays the tax on $40 she is paying tax on the monies that she originally contributed. On the other hand if B pays the tax he is paying all the tax on $40 earned by the partnership, and a part of A's original cash contribution is still available to return to A upon liquidation. Most drafters determine that the Year One profits (minus the preferred return) should be allocated equally to A and B under the allocation waterfall. A pays tax on $30 income ($10 preferred return) plus $20 (½ of remaining income) and B pays tax on $20 (1/2 of remaining income).

CAPITAL ACCOUNTS

	"A"	"B"
Distributions		
Cash Contributed	$100	$-0-
Year 1 Cash Dist[12].	<50>	
Income Allocation		
A's Pref. Rtn. Y1	$10	
Year 1 Income ($50-10)	20	20
Ending Y1 Cap Acct	$ 80	$20

[12] A gets his annual return of $10 and the partial return of his capital, or $40, before B receives any distributions.

Back to Table of Contents

As previously stated A gets all $50 under the distribution waterfall because of A's preferred return and their agreement that A's capital be returned before B takes any cash distributions. This is likely to cause a hardship for B. Many modern partnership agreements provide for cash advances by the partnership to pay partners' taxes in order to ameliorate B's problem.

Transactions more complicated than Example One can have multiple distribution waterfalls that apply. One distribution waterfall may distribute cash from operations, while another distributes cash from a sale or refinancing. The allocation waterfall must track these varying cash distribution waterfalls, and their effect on partners' capital accounts. In addition, the allocation waterfall also must include profit or loss allocations to make-up for losses or profits previously allocated to one or more partners that are out of balance with prior year cash distributions to avoid favoring some and short-changing others in the event of liquidation. Drafting allocation waterfalls to match complex distribution waterfalls is difficult and susceptible to drafting errors.

For example, allocation waterfalls and distribution waterfalls don't reach the right end result in instances where the capital account maintenance rules have allocated items but there is not enough income to allocate in order to true up the capital account ending balances to where the partners would expect. This can occur where a partnership is liquidated before it has sufficient income to true up the capital accounts.

Example Two demonstrates a situation where the partnership fails to generate sufficient income in a later year causing profit allocations not to catch up to the distributions made, throwing the capital accounts out of balance with the amount that the partners expect to be distributed.

EXAMPLE TWO: Assume the same facts as Example One. As previously seen the partnership has $50 of income in year one and distributes that $50 income to A according to A and B's business deal: A receives an annual preferred return of $10 and return of her original capital contribution of $100 before B receives any cash distributions. In year two the partnership has no income or loss. It liquidates at the end of year two and distributes $100.

Under the cash distribution waterfall A is entitled to the return of her $100 initially contributed as capital. But she has already received a return of $40 capital in year one. She is also entitled to a $10 preferred return in both years one and two. She already has been paid her preferred return in year one. Finally, as part of their business deal, A and B split equally any residual cash distributions after the return of A's capital. How does this work out?

Back to Table of Contents

CASH AVAILABLE FOR DISTRIBUTION UPON LIQUIDATION

A's Cash Contributed	$100
Y1 Income	50
Cash Dist. To A	<50>
Y2 Income	-0-
Ending Cash Balance	$100

At the end of year two $100 cash is available to distribute to A and B in liquidation of the partnership. As part of the business deal A is entitled to her $10 preferred return in year two as well. She also is entitled to her unreturned capital of $60 ($100 capital contribution minus $40 return of capital in year one). Subtracting A's preferred return and unreturned capital from partnership capital at the end of year one leaves $30 ($100 minus A's preferred return of $10 and A's unreturned capital of $60). This sum should be distributed equally to each: $15 to A and $15 to B. Thus A should receive in liquidation $85 ($70 plus $15) and B should receive a $15 distribution. Under the regulatory allocation regime this will not take place because the liquidating distributions must be in accordance with positive capital account balances. Because there is no year two income to distribute or allocate A will not receive or be credited in her capital account balance with the promised preferred return in year two. Therefore the capital account balances controlling liquidating distributions remain equal to the ending year one capital account balances above: A's ending capital account balance is $80 and B's ending capital account balance is $20. Upon liquidation in accordance with positive capital account balances A will receive $80 and B will receive $20.

If the target allocation approach used the cash distribution waterfall would control liquidating distributions. A would receive $85 because the distribution waterfall would distribute to A her the following: (i) $10 year two preferred return, (ii) $60 remaining unreturned capital, and (iii) $15 (1/2 remaining balance of $30); and B would receive $15. Regulatory allocations favor B in this instance.

Back to Table of Contents

V. DRAFTING TARGET ALLOCATIONS.

Target allocations focus on how cash is distributed and to whom. Cash is king. Cash distributions to partners are predictable during operations and upon liquidation. Allocations of profits or losses and the extensive tax boilerplate provisions found in most partnership agreements can be ignored, even though they are (and should be) included in the agreement. They do not affect the manner in which cash or property is distributed to the partners during the partnership's life or when it is wound up and liquidated.

Target allocation agreements focus almost exclusively on the distribution waterfall and getting it right. The distribution waterfall determines the manner in which cash or other property will be distributed among the partners, without any reference to capital account balances.

But the capital account balances are not ignored. Most target allocation agreements "true up" the partners' capital account balances at the end of each taxable year through a hypothetical liquidation where it is assumed that all of the partnership's assets are sold for an amount equal to their book value and all liabilities are settled in cash according to their terms. Cash then is distributed according to the distribution waterfall in the partnership agreement. Profits and losses are allocated in a manner to cause the partners' respective capital account balances to equal the amount that each partner would receive under the distribution waterfall if the partnership liquidated. In this way cash is more likely to end up in the pockets of the partners that should receive it, without distortions caused by the capital account maintenance rules. Use of the target capital account approach avoids the need to draft multiple tiers of profit and loss allocations, and so drafting mistakes are avoided.

Target allocation agreements, however, do not satisfy the regulatory "safe harbors." But target allocations may satisfy the regulatory economic effect equivalence test or the partners' interest in the partnership test.[13]

In some instances practitioners adopt a target allocation approach that simply states that allocations of tax items should be made to "track" the distribution provisions—giving up the year-end deemed liquidation and capital account maintenance rules entirely or allocations of income or loss are used to "fill up" the partners ending capital account balances. Drafting distribution waterfalls are the focus of these type of agreement as well. Once the distribution waterfall is set, the drafter develops tax allocation provisions to track the cash distribution priorities. Essentially this is the same approach as the traditional "liquidate in accordance with capital account" provisions in the regulatory allocations except the final distributions are based on a formula, not on ending capital account balances. This approach also falls short of the regulatory safe harbors. But it too may satisfy the equivalence or partners' interests in the partnership tests.

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[13] Treas. Reg. § 1.704-1(b)(2)(ii)(*i*) and §1.704-1(b)(3) respectively.

VI. SPOTTING TARGET ALLOCATION AGREEMENTS.

A simple way to spot whether an agreement is a target allocation agreement is to determine whether the partners receive liquidating distributions in accordance with their positive capital accounts balances. Examining the terms of the liquidation and winding up provisions contained in an agreement should answer that question. If the agreement states that once the creditors are fully paid, any remaining assets are to be distributed to the partners in accordance with their positive capital account balances, the agreement follows the traditional regulatory approach. If, however, any remaining assets after the payment of creditors are to be distributed in accordance with the distribution waterfall, the agreement follows the target allocation approach.

VII. CONCLUSION.

Target allocations in complex partnership and LLC agreements are here to stay—until the IRS says otherwise. In an era where cash is king target allocation agreements get the business deal right more often than not. And they are more understandable to layperson and professional alike. But that’s not to say that caution isn’t warranted. Until we have approval from the IRS using target allocations can lead to sleepless nights.

This paper isn’t to convince you that the use of target allocations is right and the use of the regulatory allocation rules is wrong. My goal is to help you recognize when you are faced with a regulatory allocation agreement or a target allocation agreement. I hope that I have started you down the path to achieve that much. Start your review by seeing how the liquidating distributions are made. That may tell you whether regulatory or target allocations are used.

THE END

Back to Table of Contents

How to Structure an Asset Sale as a Stock Sale for Tax Purposes

By David S. Peck and Alexander S. Farr[1]

As every tax lawyer is undoubtedly aware, a frequent topic of negotiation between a seller of a business conducted by a corporation and a potential buyer involves whether the transaction will take the form of a stock or asset purchase.[2] A buyer will typically want to acquire assets of a target corporation for two reasons. First, such a structure would allow the buyer to take a cost basis in the assets of the target. Second, it would allow the buyer to acquire the assets of the target's business while assuming only certain specified liabilities—the buyer could leave unknown or unwanted liabilities behind with the target.[3] In contrast, in a stock purchase, the target would retain the historic tax basis in its assets and all of its historic liabilities. The seller will generally prefer a stock sale for the opposite reasons—a stock sale would avoid a corporate level tax that would be present in an asset sale and a stock sale would transition the liabilities of the business to the buyer.

Section 338[4] provides for a transaction structure that, in the right circumstances, can be utilized to achieve a compromise between the tax and liability allocation goals of the parties. More specifically, a purchasing corporation that makes a qualified stock purchase of a target corporation can elect for the transaction to be treated as though the target corporation sold its assets for tax purposes, even though for non-tax purposes the transaction will continue to be treated as a stock purchase.[5] The result is that the buyer receives a step-up in the tax basis of the target's assets, but the target retains all of its historic liabilities. From the seller's standpoint the transaction would trigger corporate level tax on any unrealized gain in the target's assets, but would not result in historic target liabilities being retained by the seller.

But what if the parties wanted to achieve the opposite effect as that provided for in Section 338—a stock purchase for tax purposes and an asset purchase for liability retention purposes? This situation could arise, for example, where an asset sale would create a substantial corporate level tax liability for the target which is undesirable to the seller, but a stock sale would result in the buyer inheriting unwanted contingent liabilities associated with the target's business. While one solution might be to structure the transaction as a stock purchase together with a fulsome indemnity provided by the seller, the buyer may be unwilling to rely on the creditworthiness of the seller for recovery or may not want to run the risk of tainting its existing business with historic liabilities of the target.

Use a Reorganization Under Section 368(a)(1)(F)

To achieve the results described above, the transaction must be structured in a manner such that (i) for tax purposes, the transaction is treated as the purchase of stock of the target, but (ii) for non-tax purposes, the target is free of historic unwanted remote and contingent liabilities ("***Contingent Liabilities***"). To effectively achieve the latter goal, the company that is acquired will likely need to be a newly formed entity ("***Newco***") that acquires all of the assets and liabilities (other than the Contingent Liabilities) of the existing target ("***Oldco***"), because it is often difficult or impossible under the applicable governing law for an entity with potential contingent liabilities to effectively eliminate those liabilities.[6] To achieve the former goal, Newco will need to be a corporation that is treated as a successor of Oldco for tax purposes.

This generally means that the transfer by Oldco of its assets and liabilities other than the Contingent Liabilities to Newco must occur pursuant to a reorganization described in Section 368(a).

Of the reorganization options available under Section 368(a), the most viable solution is a reorganization described in Section 368(a)(1)(F) (an "***F Reorganization***"). An F Reorganization is defined as a mere change in identity, form, or place of organization of one corporation, however effected.[7] An F Reorganization can be effected by the transfer of assets from one corporation to another newly formed corporation if:

- All stock of the resulting corporation is issued in respect of stock of the transferring corporation;
- There is no change in the ownership of the corporation in the transaction, except a change that has no effect other than that of a redemption of less than all the shares of the corporation;
- The transferring corporation completely liquidates in the transaction[8]; and
- The resulting corporation does not hold any property or have any tax attributes immediately before the transfer.[9]

In this context, the rules applicable to an F Reorganization provide two advantages as compared to other types of asset reorganizations, such as reorganizations under Sections 368(a)(1)(C) and 368(a)(1)(D).[10] First, F Reorganizations are generally not subject to step-transaction principles, and thus if an F Reorganization occurs within a larger transaction, events that precede or follow the F Reorganization will not cause the F Reorganization to fail to qualify as such.[11] Second, there is no requirement that the historic stockholders maintain "continuity of interest" or any other requisite amount of ownership following the F Reorganization.[12] In contrast, a non-divisive reorganization under Section 368(a)(1)(D) requires that the historic target shareholders retain "control" immediately after the transaction and, under step-transaction principles, a subsequent sale pursuant to the overall plan would likely be treated as violating the control requirement.[13] Similar step-transaction concerns may be relevant to transactions attempting to qualify as a reorganization under Section 368(a)(1)(C). Therefore, an F Reorganization appears to be the most viable option.

If the transfer from Oldco to Newco can be successfully structured as an F Reorganization, the following tax consequences would result:

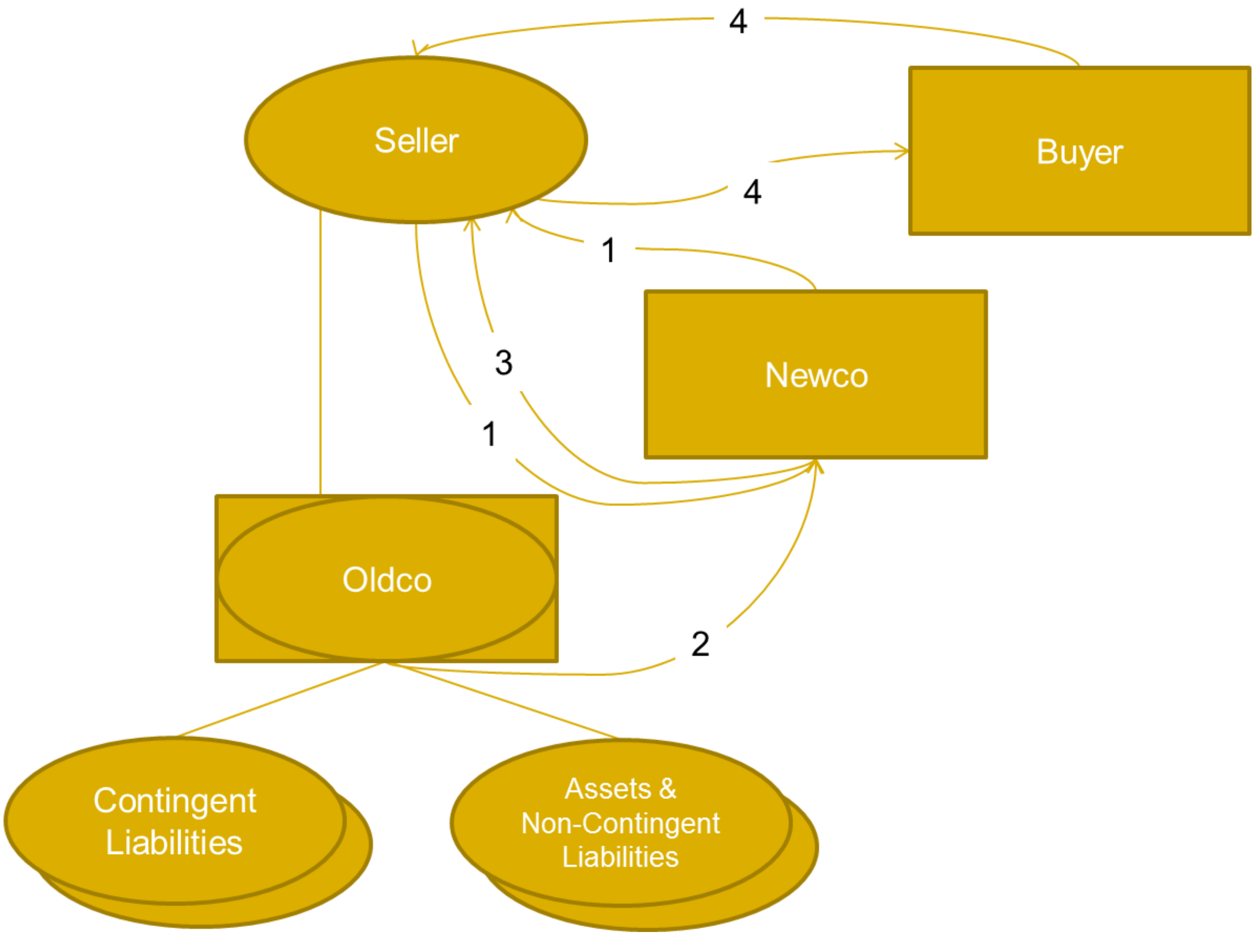
- Seller would recognize no gain or loss on the exchange of its shares of Oldco for shares of Newco;[14]
- Seller would take a basis in the shares of Newco equal to its former basis in the shares of Oldco;[15]
- Oldco would recognize no gain or loss upon the contribution of its assets to Newco and simultaneous liquidation.[16]
- Newco would take a carryover basis and holding period in Oldco's assets;[17] and
- The subsequent sale of Newco would be treated as a stock sale.

Having decided that the most viable manner of achieving the desired tax objective is to design a two-step structure whereby (i) Oldco transfers its assets and liabilities other than the

Back to Table of Contents

Contingent Liabilities to Newco in an F Reorganization in a manner that insulates Newco from the Contingent Liabilities and (ii) thereafter, buyer purchases the stock of Newco, the question becomes how best to effectively design and implement such a structure. Following is a discussion of two such proposed structures that find support based on existing authorities.

Liability Spin-Off Structure



Transaction Steps

Step 1: Seller contributes all of its Oldco shares to Newco in exchange for all of Newco's stock and simultaneously Oldco "liquidates" for tax purposes by converting to a limited liability company whose existence is disregarded as separate from Newco.

Step 2: Oldco transfers all of its assets to Newco subject to all liabilities (other than the Contingent Liabilities).

Step 3: Newco transfers its interest in Oldco to seller.

Step 4: Seller sells the stock of Newco to buyer and retains Oldco (which continues to hold the Contingent Liabilities).

Intended Tax Consequences

The contribution in Step 1 by seller of all of its shares in Oldco to Newco solely in exchange for all of Newco's stock and simultaneous conversion of Oldco to a limited liability company (which conversion will be treated as a liquidation for tax purposes) is intended to qualify as an F Reorganization, with Newco being treated as the successor of Oldco in the reorganization.[18]

The transfer in Step 2 by Oldco of all of its assets to Newco subject to all liabilities related to those assets other than the Contingent Liabilities is a non-event for tax purposes.[19] Because Target exists only as a disregarded branch of Newco, there are no tax consequences associated with such transfer—Newco is already treated as directly owning such assets.

The distribution in Step 3 by Newco of all the membership interests in Oldco to seller should generally not trigger significant tax consequences. If viewed as a distribution, Newco would recognize gain but not loss on the distribution under Section 311(b) and the tax consequences of the distribution to the seller would be determined under Section 301 or Section 302. In any event, assuming that Oldco has little or no assets and the Contingent Liabilities are *de minimis* or remote, no significant tax consequences should result from the distribution.

Finally, the acquisition in Step 4 by buyer of all of the shares of Newco from seller for cash is intended to yield the desired tax consequences afforded to a stock sale.

The primary issue associated with this structure is whether the retention of the Contingent Liabilities by Oldco following the transfer of its assets to Newco and the related distribution of Oldco membership interests by Newco adversely impacts the qualification of Step 1 as an F Reorganization. Strong arguments can be made that the F Reorganization should not be adversely impacted.

First, immediately following Step 1 (the purported F Reorganization), Newco is treated as owning (through its disregarded subsidiary, Oldco) all of the assets and liabilities formerly owned by Oldco, including the Contingent Liabilities. It is not until Step 3 that the Contingent Liabilities cease to be treated as being held by Newco. As noted above, an F Reorganization should not be impacted by subsequent transactions event if such subsequent transactions are part of a prearranged plan.[20] Accordingly, a strong argument can be made that the removal of the Contingent Liabilities from under the Newco umbrella in Step 3 should not be stepped-together and taint the otherwise qualifying F Reorganization in Step 1 (the "***No Step-Transaction Argument***").

Second, while an F Reorganization generally involves a mere change in identity or form, strong arguments can be made that the failure of Newco to ultimately assume the Contingent Liabilities should not adversely affect the F Reorganization status, at least where the likelihood of materialization of those liabilities is contingent and remote or such liabilities are considered *de minimis* (the "***De Minimis or Remote Liability Argument***"). Authorities allow a *de minimis* amount of assets or liabilities to be retained and not transferred to the successor corporation in F Reorganizations.[21] Further, liabilities that are too speculative or contingent to reasonably estimate have frequently been ignored for tax purposes in the context of a sale transaction, at least until such liabilities materialize.[22]

PLR 200633008

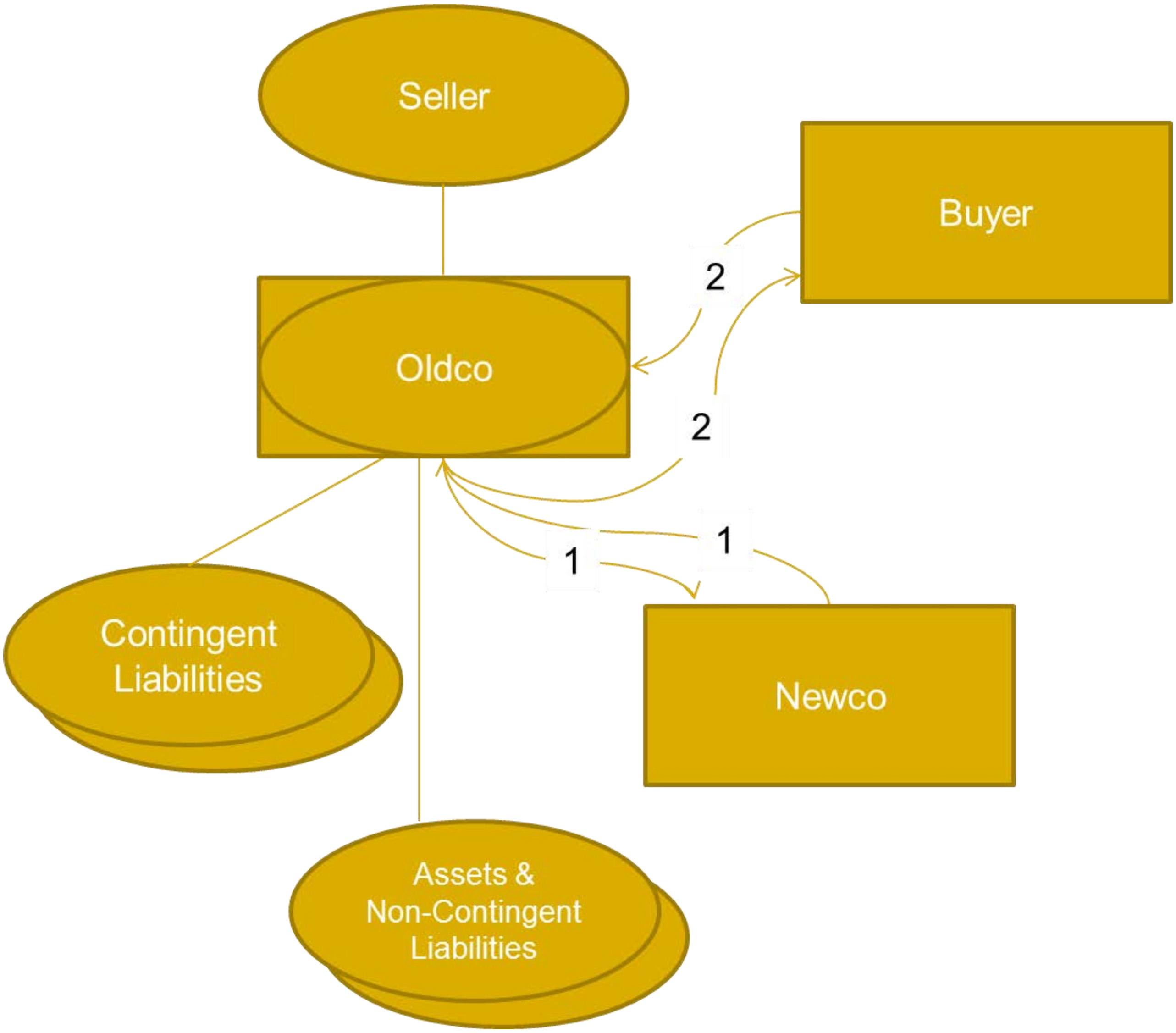
The Internal Revenue Service ("***IRS***") addressed the Liability Spin-Off Structure in PLR 200633008[23] which involved an entity, Oldco that was originally a C corporation but which subsequently made an S election. Oldco was a holding company that held subsidiaries that were disregarded for tax purposes, some of which engaged in Business A. The shareholders of Oldco wanted to dispose of Business A by selling Oldco stock but potential buyers were concerned about Oldco's contingent liabilities related to its former Business B.

Oldco's shareholders formed a new corporation, Newco, which in turn formed a new LLC, into which Oldco merged with LLC surviving and Oldco stock being converted into Newco stock. LLC succeeded to all assets and liabilities of Oldco under applicable state merger law. After the merger LLC transferred its interest in the subsidiaries holding Business A assets to Newco. Subsequently, Newco distributed the membership interests in LLC (which retained the contingent liabilities) to the shareholders.

The IRS ruled that the steps beginning with the Oldco merger up through the transfer of the Business A subsidiaries qualified as an F Reorganization and furthermore that the distribution of the LLC interests in the last step did not otherwise prevent qualification of the transaction as a good reorganization.

Back to Table of Contents

Liability Retention Structure



Transaction Steps

Step 1. Oldco transfers all of its assets to Newco in exchange for the assumption by Newco of all liabilities of Oldco other than the Contingent Liabilities and the issuance of shares of Newco, following which Oldco converts to an LLC. Oldco retains the Contingent Liabilities.

Step 2. Oldco sells its shares of Newco to buyer for cash.

Intended Tax Consequences

Step 1 is intended to qualify as an F Reorganization in which Newco is treated as the successor to Oldco. Since Oldco converts to a limited liability company, it will be treated as liquidating and will become an entity whose existence is disregarded as separate from seller for tax purposes.

Step 2 is intended to be treated as a sale by seller of the stock of Newco.

The primary tax issue related to the Liability Retention Structure is the same as the Liability Spin-Off Structure—whether the failure by Newco to assume the Contingent Liabilities prevents Newco from being treated as the successor to Oldco in an F Reorganization. Unlike the Liability Spin-Off Structure, in the Liability Retention Structure Newco is never treated as holding the Contingent Liabilities. Thus, the No Step-Transaction Argument discussed above would not apply (or at least would not apply with equal force) to the Liability Retention Structure. However, the De Minimis or Remote Liability Argument discussed above should apply with equal force to the Liability Retention Structure.

PLRs 7814033 and 201003014

The Liability Retention Structure has support in two IRS private letter rulings. In PLR 7814033,[24] Oldco manufactured and sold hardware and parts for mining and machinery and had recently terminated its separate business of manufacturing and selling boilers. Oldco's management sought to isolate Oldco from contingent product liabilities that might arise from the abandoned business. Oldco transferred all of its assets and liabilities (other than the contingent liabilities) to Newco in exchange for all of Newco's stock. Oldco then distributed the Newco stock to its shareholders in a liquidating distribution made in connection with the dissolution of Oldco. The IRS ruled that the transfer by Oldco of assets and liabilities to Newco for Newco stock followed by Oldco's liquidation would constitute a good F Reorganization even though Newco did not assume the contingent liabilities. It is notable that while this ruling did not consider a post-reorganization disposition of Newco, as discussed above, the step-transaction doctrine should not apply to cause subsequent events to taint an otherwise qualifying F Reorganization. Thus, such a sale should not adversely impact the F Reorganization qualification.

The IRS also ruled favorably in a more recent ruling, PLR 201003014,[25] which involved a more complicated set of transactions that were directed at separating contingent liabilities prior to a sale of an interest in a company. Under the facts of the ruling, [26] a corporate shareholder, X, sought to dispose of its entire interest in Oldco (an entity which was also indirectly partially owned by company Y) by selling all of its Oldco stock to Purchaser. However, Purchaser did not want to acquire Oldco stock due to concerns about some of Oldco's contingent liabilities. In the transaction described in the ruling, Y first "sold" its interest in Oldco to X for a note and Oldco then distributed all of its assets and liabilities to X and dissolved. X then contributed all of the assets and liabilities (except for the contingent liabilities) formerly held by Oldco to Newco in exchange for all shares of Newco. X transferred a proportionate amount of the Newco shares to Y in satisfaction of the note. X then sold its remaining interest in Newco to Purchaser free of the contingent liabilities. In its ruling, the IRS treated the transaction as a direct transfer by Oldco of all of its assets and liabilities (except the contingent liabilities) to Newco for all of the Newco stock followed by a liquidation of Oldco in which Newco stock was distributed pro rata to X and Y—and ruled that such transaction qualified as an F Reorganization.

Conclusion

The two-step F Reorganization followed by Newco stock sale is the most (and possibly only) viable structure for separating contingent and remote liabilities from a corporation prior to a disposition that is treated as a sale of stock of such corporation for tax purposes. There are at least two structures to accomplish such a goal that have support in published rulings, but there may be other approaches, so long as the general requirements for F Reorganization treatment are met. The level of comfort that a seller or its tax advisor can reach when analyzing such a structure will likely depend upon the level of materially and likelihood of materialization of the contingent liabilities at issue. Tax advisors should work closely with corporate, securities or reorganization lawyers to make sure that the transaction has both the desired tax and liability allocation effects, and that any risk of tax exposure from the transaction is properly addressed and allocated to the appropriate parties in the applicable transaction documents.

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[1] David Peck is a tax partner and Alex Farr is a tax associate in the Dallas office of Vinson & Elkins L.L.P.

[2] The focus of this article is on the federal income tax consequences of a sale of a nonconsolidated C corporation to an unrelated corporate purchaser, although many of the principles discussed herein would apply equally to the sale of a subsidiary member of a consolidated group or an S corporation.

[3] Of course the buyer will often require the seller to indemnify it for breaches of representations, warranties and covenants related to the target and its business. However, an indemnity is often not as helpful to a buyer as avoiding the assumption of a liability altogether because the indemnity may be limited as to time or amount or may be dependent upon the creditworthiness of the seller.

[4] All Section references herein are to the Internal Revenue Code of 1986, as amended (the "***Code***").

[5] *See* Sections 338(g) and 338(h)(10).

[6] That is not to say that the formation of a new entity and transfer of assets and non-contingent liabilities to the new entity will always be effective under applicable law of shielding the new entity from contingent liabilities of the transferring entity. Depending on the particular nature of the liabilities and other circumstances, statutory liability, successor or transferee liability or fraudulent conveyance rules may operate to cause the new entity to be partially or fully liable for the contingent liabilities even in the absence of a contractual assumption thereof.

[7] Section 368(a)(1)(F).

[8] Prop. Treas. Reg. Sec. 1.368-2(m)(1)(ii) provides that legal dissolution of the transferring corporation is not required, and the mere retention of a nominal amount of assets for the sole purpose of preserving the corporation's legal existence will not disqualify the transaction as a mere change. Further, a deemed liquidation such as a conversion to a disregarded entity should satisfy the liquidation requirement. *See*, *e.g.*, Prop. Treas. Reg. Sec. 301.7701-3(g)(1)(iii).

[9] Prop. Treas. Reg. Sec. 1.368-2(m); Rev. Rul. 87-27, 1987-1 CB 134; PLR 201001002 (Jan. 8, 2010); PLR 9111033 (Dec. 17, 1990). Much like other reorganizations, F Reorganizations do require a valid business purpose to be respected. However, one would think that the separation of contingent liabilities and facilitation of a subsequent sale should be sufficient.

[10] Other types of potential reorganizations under Section 368(a) involve state law mergers or stock transfers which generally would not be effective under applicable law in allowing Newco to avoid the Contingent Liabilities of Oldco.

[11] Rev. Rul. 2003-48, 2003-1 CB 863; Prop. Treas. Reg. Sec. 1.368-2(m)(3)(ii).

[12] Prop. Treas. Reg. Sec. 1.368-2(m)(2).

[13] Section 368(a)(1)(D). "Control" for purposes of an acquisitive "D" reorganization is a 50% vote and value test pursuant to Section 368(a)(2)(H)(i). In the Section 351 context, whether a post-transaction disposition of the stock to a third party violates the "control" requirement depends on whether the entire transaction can be considered to be part of a single plan under step-transaction doctrine or whether a binding commitment existed requiring the subsequent transfer. *See Intermountain Lumber Co. v. Comm'r*, 65 T.C. 1025 (1976). Such an analysis most likely

Back to Table of Contents

applies to the "D" reorganization context for purposes of testing the "control" requirement. *See McDonald's Restaurants of Illinois, Inc. v. Comm'r*, 688 F.2d 520 (7th Cir. 1982).

[14] Section 354(a)(1).

[15] Section 358(a).

[16] Section 361(a).

[17] Sections 362(b) and 1223(2).

[18] *See* Rev. Rul. 2008-18, 2008-13 IRB 674 (March 7, 2008).

[19] Note that while it is beyond the scope of this article, consideration should be given as to whether the distribution by Oldco of all of its assets but retention of only the Contingent Liabilities would be effective to isolate Newco from all exposure related to the Contingent Liabilities under applicable law. Perhaps a guarantee provided to Oldco by Parent with respect to the Contingent Liabilities up to the amount of proceeds from the sale of Newco would reduce the fraudulent conveyance or similar concerns.

[20] *See supra* note 11.

[21] Rev. Rul. 66-284, 1966-2 CB 115; Prop. Treas. Reg. Sec. 1.368-2(m)(7)(ii); PLR 200633008 (May 10, 2006).

[22] *See*, *e.g.*, *Albany Car Wheel Co. v. Comm'r*, 333 F.2d 653 (2nd Cir. 1964); s*ee also*, Lynch, "Transferring Assets Subject to Contingent Liabilities in Business Restructuring Transactions," 67 Taxes 1061 (December 1989); Keyes, "The Treatment of Liabilities in Taxable Asset Acquisitions," 50 NYU Inst. on Fed. Tax'n § 21.04[1] (1992).

[23] May 10, 2006.

[24] PLR 7814033 (Jan. 6, 1978).

[25] PLR 201003014 (Jan. 22, 2010).

[26] Note that the facts have been simplified for purposes of this discussion as the actual ownership structure involved a series of additional intermediate and international entities.

Back to Table of Contents

Tax Exemptions for Charitable Single-Member Limited Liability Companies

by Terri Lynn Helge and David M. Rosenberg

I. Introduction.

Introduction. This summer, the IRS issued long-awaited guidance on the deductibility of charitable contributions made to a single-member limited liability company ("SMLLC") that is wholly-owned by a charitable organization exempt from federal income tax as a organization described in Section 501(c)(3).[1] Previously, in a 2001 private letter ruling, the IRS confirmed that a SMLLC wholly-owned by a U.S. charity did not need to submit a separate application for recognition of federal income tax exemption, but declined to rule on whether contributions made to the SMLLC would be deductible under Section 170 as charitable contributions.[2] An article in the IRS Continuing Professional Education Text for the fiscal year 2001 stated that "[g]uidance on this issue will be forthcoming in the near future."[3] Notice 2012-52 provides this guidance.[4] In Notice 2012-52, the IRS ruled that a contribution to a domestic SMLLC that is wholly owned by a U.S. charity would be treated as a deductible charitable contribution, assuming all the requirements of Section 170 are met.[5] This article discusses the requirements for federal income tax exemption of a SMLLC and the deductibility of contributions made to the SMLLC as well as the availability of Texas state tax exemptions for the SMLLC.

II. Federal Tax Exemption.

A. <u>Section 501(c)(3) Exemption</u>. Under the choice of entity regulations, a SMLLC is disregarded as an entity separate from its owner for federal income tax purposes, unless a timely election is made to treat the SMLLC as a corporation for federal income tax purposes.[6] As a disregarded entity, the activities of the SMLLC are treated as a branch or division of its owner.[7] Thus, a U.S. charity that is the sole member of a SMLLC treated as a disregarded entity must report the operations and finances of the SMLLC on the charity's own annual information return (Form 990/990PF).[8] Since the SMLLC is disregarded as a separate entity for federal income tax purposes, the Section 501(c)(3) exempt status of the charity-member extends to the operations and activities of the SMLLC. No separate determination of exemption as a Section 501(c)(3) organization is required for a charitably-owned SMLLC that is treated as a disregarded entity. By using a SMLLC, a charity can avoid the expense and time delay of seeking a separate determination of exemption for activities that the charity would like segregated in a

[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.
[2] *See* Priv. Ltr. Rul. 200150027 (Aug. 7, 2001).
[3] Richard A. McCray & Ward L. Thomas, *Limited Liability Companies as Exempt Organizations: Update*, 2001 EO CPE Text, chpt. B, at 28, available at http://www.irs.gov/pub/irs-tege/eotopicb01.pdf.
[4] Practitioners who deal with the IRS on a regular basis will not be surprised to learn that the IRS considers 11 years the "near future."
[5] Notice 2012-52, 2012-35 I.R.B. 317.
[6] *See* Treas. Reg. § 301.7701-2(c)(2)(i).
[7] *See* Treas. Reg. § 301.7701-5(a).
[8] Ann. 99-102, 1999-2 C.B. 545.

separate entity to, for example, minimize exposure to potential liability from these activities for the charity.

Nonetheless, caution should be taken in forming a SMLLC to conduct activities of the charity-member. Because the operations and activities of the SMLLC treated as a disregarded entity are attributable to the charity-member, it is important to consider the potential effect the operations and activities of the SMLLC may have on the tax-exempt status of the charity-member. For example, if the SMLLC conducts an unrelated business activity that would jeopardize the tax-exempt status of the charity-member if conducted by the charity-member directly, the potential risk is not minimized by conducting the unrelated business activity through a SMLLC instead. Collectively, the SMLLC's and the charity-member's operations must primarily further the charitable purpose for which the charity-member was granted tax exemption. Furthermore, all of the activities of the SMLLC are considered activities of the charity-member for purposes of the unrelated business income tax[9] and the excise taxes imposed under Chapter 42 of the Code (e.g., prohibition on self-dealing and excess benefit transactions with disqualified persons).[10] Thus, the charity-member should monitor the SMLLC's activities carefully to ensure that the SMLLC does not conduct activities that would call the charity-member's tax exempt status into question.

In its 2001 Continuing Professional Education Text, the IRS stated that a SMLLC treated as a disregarded entity does not need to independently satisfy the organizational test required of Section 501(c)(3) charitable organizations.[11] However, the articles of organization of the SMLLC cannot prohibit the SMLLC from operating exclusively for tax exempt purposes.[12] Moreover, if the SMLLC's articles of organization do not satisfy the organizational test, the article suggests closer scrutiny by an examining agent of the SMLLC's activities to ensure compliance with the operational test required of Section 501(c)(3) charitable organizations.[13] Accordingly, it may be prudent to structure a SMLLC to satisfy the organizational test under Section 501(c)(3) by including the following provisions in its articles of organization:

- o The activities of the SMLLC are limited to one or more exempt purposes and the SMLLC is operated to further its charity-member's exempt purposes;

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[9] The unrelated business income tax applies to a trade or business activity that is regularly carried on by a charity and the conduct of which is not related to the accomplishment of the charity's exempt purposes. *See* I.R.C. § 511.

[10] *See* I.R.C. §§ 4940—4967.

[11] McCray & Thomas, *supra* note 3, at 28. Generally, in order to meet the Section 501(c)(3) organizational test, the articles of organization of the entity (i) must limit its purposes to one or more exempt purposes, (ii) may not empower the entity to engage in activities which are not in furtherance of its exempt purposes, other than to an insubstantial degree, (iii) may not empower the entity to engaged in prohibited political campaign intervention or lobbying activity, and upon dissolution of the entity, its assets must be distributed for exempt purposes by operation of law or by provision in the articles of organization. Treas. Reg. § 1.501(c)(3)-1(b).

[12] McCray & Thomas, *supra* note 3, at 28.

[13] *Id*. In general, the operational test requires the entity to engage primarily in activities that accomplish its exempt purposes and to not engage in a substantial amount or lobbying activity or any prohibited political campaign intervention. Treas. Reg. § 1.501(c)(3)-1(c). In addition, no part of the net earnings of the entity may inure to the benefit of private shareholders or individuals. *Id*.

- Transfer of a membership interest in the SMLLC is prohibited except to a charitable organization or governmental unit, and only with the approval of the charity-member;
- Upon dissolution of the SMLLC, its assets will be distributed to the charity-member or for one or more exempt purposes as determined by the charity-member;
- No distributions will be made from the SMLLC to a member who ceases to qualify for exemption as a charitable organization; and
- The SMLLC is prohibited from conducting any activity that is not permitted of a charitable organization exempt from federal income tax as a Section 501(c)(3) organization.

B. Charitable Contribution Deduction. Notice 2012-52 provides that a contribution to a domestic SMLLC that is wholly owned by a U.S. charity is treated as a deductible charitable contribution, assuming all the requirements of Section 170 are met.[14] Section 170(a) allows donors to deduct certain charitable contributions in computing taxable income. A deductible charitable contribution generally is made to or for the use of a U.S. organization which has been determined to be organized and operated for charitable purposes by the IRS.[15] A donor may verify that the charity qualifies as an organization that is eligible to receive tax-deductible charitable contributions by requesting a copy of the charity's IRS determination letter or verifying the status of the organization through the IRS "Exempt Organizations Select Check" on the IRS website.[16] However, a SMLLC treated as a disregarded entity will not have its own IRS determination letter and will not be listed in the Exempt Organization Select Check database, potentially causing confusion for some donors. Therefore, even though Notice 2012-52 allows contributions made to the SMLLC to be deducted, the charity-member may need to provide more information to potential donors to alleviate concerns regarding the deductibility of the contribution.

Notice 2012-52 also provides that even though the contribution is made to the SMLLC, the charity-member is considered the donee organization for purposes of the substantiation and disclosure requirements. For charitable contributions of $250 or more, a donor generally is allowed a deduction only if the contribution is substantiated by a contemporaneous written acknowledgment.[17] That acknowledgment must be from the charity and must generally state: (i) the amount of cash and a description of any noncash property contributed by the donor; (ii) whether the charity provided any goods or services in consideration for the property contributed; and (iii) a description and good faith estimate of the value of any goods or services provided by the charity.[18] A written acknowledgment is contemporaneous if the donor obtains the acknowledgment on or

[14] Notice 2012-52, 2012-35 I.R.B. 317.
[15] *See* I.R.C. § 170(c)(2). Organizations with annual gross receipts of $5,000 or less and churches are not required to apply for recognition of tax-exempt status, though many churches voluntarily apply for recognition of tax-exempt status so that the church has an IRS determination letter of its exempt status to show to potential donors.
[16] Exempt Organizations Select Check is available at http://www.irs.gov/Charities-&-Non-Profits/Exempt-Organizations-Select-Check.
[17] I.R.C. § 170(f)(8)(A).
[18] I.R.C. § 170(f)(8)(B).

before the earlier of the due date (including extensions) of the return for the taxable year in which the contribution was made, or the date on which the donor actually files such return.[19] Notice 2012-52 recommends that "[t]o avoid unnecessary inquiries by the [IRS], the charity is encouraged to disclose, in the acknowledgment or another statement, that the SMLLC is wholly owned by the U.S. charity and treated by the U.S. charity as a disregarded entity."[20]

Recently, the IRS has won several court cases in which the deduction for a contribution made to a charity was denied by the IRS because the donor did not have adequate contemporaneous written acknowledgement from the charity or other required substantiation of the charitable contribution.[21] In particular, the Tax Court rejected a taxpayer's "substantial compliance" argument in one case stating:

> We recognize that this result is harsh—a complete denial of charitable deductions to a couple that did not overvalue, and may well have undervalued, their contributions—all reported on forms that even to the Court's eyes seemed likely to mislead someone who didn't read the instructions. But the problems of misvalued property are so great that Congress was quite specific about what the charitably inclined have to do to defend their deductions, and we cannot in a single sympathetic case undermine those rules.[22]

Due to the IRS's and the courts' insistence on perfect compliance with the acknowledgment and substantiation requirements, it is curious that the IRS is not more specific on the requirements for properly acknowledging a contribution made to a SMLLC. In particular, the IRS's recommendation, rather than requirement, that the acknowledgment contain a statement about the disregarded entity status of the SMLLC is a bit perplexing. It may be prudent, therefore, for a charity-member to use a separate form of acknowledgment for contributions made to the SMLLC which contains the recommended disclosure about the disregarded entity status of the SMLLC.

Finally, Notice 2012-52 clarifies that the limits on the deductibility of charitable contributions set forth in Section 170(b) are applied as if the contribution were made to the charity-member of the SMLLC. Section 170(b) establishes limits on the maximum amount of the cash or property contributed to a charitable organization that may be deducted in a given year. For individuals, these limits are based on specified percentages of the donor's adjusted gross income depending on the type of charity to which the contribution was made (public charity or private foundation) and the type of property contributed to the charity.[23] In addition, if the donor contributes property to the charity instead of cash, the amount deductible may be limited to the donor's cost basis rather

[19] I.R.C. § 170(f)(8)(C).
[20] Notice 2012-52, 2012-35 I.R.B. 317.
[21] *See, e.g.*, Mohamed v. Comm'r, T.C. Memo 2012-152; Durden v. Comm'r, T.C. Memo 2012-140; Cohan v. Comm'r, T.C. Memo 2012-8; DiDonato v. Comm'r, T.C. Memo 2011-153.
[22] Mohamed v. Comm'r, T.C. Memo 2012-152.
[23] *See* I.R.C. § 170(b).

than the fair market value.[24] Thus, if the SMLLC is wholly-owned by a private foundation, contributions to the SMLLC are governed by the deduction limits applicable to contributions to private foundations. Likewise, if the SMLLC is wholly-owned by a church, school, hospital, publicly supported organization or other public charity, contributions to the SMLLC are governed by the deduction limits applicable to contributions to public charities.

Notice 2012-52 is effective for contributions to SMLLCs made on or after July 31, 2012. However, a taxpayer may rely on Notice 2012-52 retroactively for taxable years in which the statute of limitations has not expired.[25]

III. State Tax Exemptions.

A. Texas Sales and Use Tax. Generally, charitable organizations exempt from federal income tax are also exempt from paying Texas sales tax on goods and services they purchase for use in their charitable activities.[26] This Texas sales and use tax exemption is also available to SMLLCs which are wholly-owned by a charitable organization described in Section 501(c)(3). Note that the Texas sales and use tax exemption does not apply to goods or services sold by the charity or the SMLLC. Thus, the charity or the SMLLC is responsible for collecting the applicable sales tax on goods or services provided by it, unless another exemption applies to the transaction under the Texas Tax Code.

B. Texas Margin Tax. The Texas margin tax (formerly known as the Texas franchise tax) applies to all business entities that are organized or conduct business in the State of Texas, including limited liability companies, partnerships and corporations. An exemption from the Texas margin tax applies to "nonprofit corporations exempt from federal income tax under Section 501(c)(3)."[27] To qualify for this exemption, the charity must provide a copy of its IRS determination letter to the Texas comptroller's office or if one is not available, evidence that the charity has applied for recognition of tax exemption with the IRS.[28] Recall that a SMLLC wholly-owned by a charity is treated as a disregarded entity for federal income tax purposes, and thus does not receive its own IRS determination letter. The Texas Comptroller's office has taken the position that the charity-member's IRS determination letter is not sufficient to grant exemption from Texas margin tax to the SMLLC,[29] even though for federal tax purposes, the SMLLC uses the same exemption granted to the charity-member. Thus, the Texas Comptroller will not grant exemption from the Texas margin tax to a SMLLC unless the SMLLC applies for and receives its own IRS determination letter.

[24] *Id*.
[25] Notice 2012-52, 2012-35 I.R.B. 317.
[26] TEX. TAX. CODE § 151.310(a)(1).
[27] TEX. TAX. CODE § 171.063(a)(1). Section 171.088 of the Texas Tax Code clarifies that the nonprofit corporation form is not essential to securing an exemption from the Texas margin tax, providing that an entity that is not a corporation but which conducts activities that would qualify for exemption if it were a corporation, is eligible for such exemption.
[28] *See* TEX. TAX. CODE § 171.063(b)-(d). Where the exemption application is pending with the IRS, the Comptroller's office will issue a provisional exemption.
[29] *See* 34 TEX. ADMIN CODE § 3.583 (2009) (Tex. Comptroller, Margin: Exemptions).

Even though the exemption from Texas margin tax is generally[30] not available to SMLLCs that do not have their own IRS determination letter, the SMLLC may nonetheless be exempt from Texas margin tax if its revenues fall below the prescribed "no-tax-due" threshold.[31] Currently, for franchise tax reports due before January 1, 2014, the no-tax-due threshold is $1,030,000.[32] The no-tax-due threshold for franchise tax reports due on or after January 1, 2014 decreases to $600,000.[33] A SMLLC that has annual revenues in excess of the no-tax-due threshold must pay the Texas margin tax on its "taxable margin," generally at a rate of one percent.[34] The taxable margin is the lowest of the following three amounts: (i) the SMLLC's revenues[35] less its cost of goods sold; (ii) the SMLLCs revenues less its compensation paid to officers and employees; and (iii) 70% of the SMLLC's revenues.[36] Note that a SMLLC which has revenues in excess of the no-tax-due threshold must generally pay the full tax computed on its taxable margin.[37] Accordingly, a charity should carefully consider the potential implications of the Texas margin tax when deciding whether to form a SMLLC to conduct certain of its activities. If the expected revenues of the SMLLC exceed the no-tax-due thresholds, in the long run it may be more beneficial for the charity to form an affiliated, controlled nonprofit corporation and apply for separate federal income tax exemption for this corporation. Even if the SMLLC's revenues fall below the no-tax-due threshold, the SMLLC is required to file a "no tax due" franchise tax report each year to maintain its good standing in the State of Texas. Since a charity exempt from the Texas margin tax is not required to file this report, this administrative nuance for the SMLLC may be overlooked by the charity.

IV. **Conclusion.** With the issuance of Notice 2012-52, the federal income tax questions regarding the use of a SMLLC wholly-owned by a U.S. charity have, for the most part, been answered. With automatic exemption for the SMLLC's activities and the eligibility of the SMLLC to receive tax-deductible charitable contributions, the popularity of

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[30] Section 171.062 of the Texas Tax Code provides an exemption from franchise taxes for a "nonprofit corporation organized for purely public charity." *Id.* § 171.062. Section 171.088 of the Texas Tax Code provides an exemption from franchise taxes for an entity that is not a corporation, but because of its activities, would qualify for exemption if it was a corporation. *Id.* § 171.038. Thus, a SMLLC that is organized for purely public charity is entitled to an exemption from Texas franchise taxes. Texas Administrative Code Rule 3.541(c)(4) provides that to be exempt from franchise taxes as organized for purely public charity, an organization must devote substantially all of its activities to the alleviation of poverty, disease, pain and suffering by providing food, clothing, drugs, treatment, shelter, or psychological counseling directly to indigent or similarly deserving members of society, with funds derived primarily from sources other than fees or changes for services. 34 TEX. ADMIN. CODE § 3.541(c)(4).

[31] *See* TEX. TAX. CODE § 171.002(d.

[32] *Id*.

[33] *Id*.

[34] *See* TEX. TAX. CODE § 171.002(a).

[35] For purposes of the Texas margin tax, revenues are generally computed with reference to the entity's federal income tax return reporting of its gross income less certain enumerated deductions, such as bad debt expense and the net distributive share of income reported to the entity from a partnership or S corporation for federal income tax purposes. *See* TEX. TAX. CODE § 171.1011.

[36] TEX. TAX. CODE § 171.101(a)(1).

[37] The Texas Tax Code provides some discounts for "small businesses" that have revenues which exceed the no-tax-due threshold by certain prescribed limits. For example, for franchise tax reports due on and after January 1, 2014, a 40% discount is allowed to an entity that has revenues between $600,000 and $700,000, and a 20% discount is allowed to an entity that has revenues between $700,000 and $900,000. TEX. TAX. CODE § 171.0021(a).

Back to Table of Contents

SMLLCs as divisions of existing charities may rise. For Texas charities, however, the application of the Texas margin tax to the SMLLC may hinder the ability to use the SMLLC form for divisions that are expected to produce sizeable revenues.

Back to Table of Contents

The Nexus Hokey Pokey:

Are you in? Are you out? Do you shake it all about?

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Back to Table of Contents

Table of Contents

I. Disclaimer 1

II. Introduction – Nexus 101 1

III. Controlling Authorities 2

A. The United States Constitution – Due process and the commerce clause 2

B. Supreme Court Cases – *Quill* 2

C. Federal Statutes – P.L. 86-272 4

IV. "Accidental" Nexus – What happens if you unknowingly step into it? 6

A. Battling standards for business activity taxes: physical presence or economic presence? 7

B. Allocation and Apportionment Formulas for Business Activity Taxes 10

C. Intangibles and Business Activity Taxes 11

E. Representatives and Sales & Use Taxes 12

V. Texas Authorities Concerning Nexus 14

A. State Use Tax 14

B. Local Use Tax 16

C. Texas Franchise Tax 16

1. The General Rule 17
2. Trade Show Exemption 18
3. Registering to do business in Texas is not enough to create nexus 19
4. Holding intangibles under the revised franchise tax 19

VI. How do you shake off nexus once you have it (or it has you)? 19

VII. Who has the burden of proof in nexus cases? 20

VIII. State Efforts to Address Nexus – Amazon Laws 20

A. New York 22

B. Arkansas 22

C. California 23

D. Colorado 24

E. Connecticut 24

F. District of Columbia 24

G. Georgia 25

H. Illinois 25

I. North Carolina 26

J. Oklahoma 26

K. Pennsylvania 27

L. Rhode Island 27

M. South Dakota 27
N. Utah 27
O. Vermont 27
IX. Issue to Watch: Cloud Computing 27
X. Federal Legislation to Watch on Nexus Issues – Changing the rules for the Nexus Hokey Pokey 28
A. Business Activity Taxes 28
B. Sales & Use Taxes 29
XI. Conclusion 29

Back to Table of Contents

I. Disclaimer

The information and views presented in this paper are those prepared by and of the authors. In particular, they do not necessarily represent the views of the Texas Comptroller of Public Accounts and are not controlling of any taxability determination that may be made by that agency. This paper provides information on general tax issues and is not intended to provide advice on any specific legal matter or factual situation. This information is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. Readers should not act upon this information without seeking professional counsel.[1]

This paper was presented on August 13, 2012, but information may have changed since that time. For example, Pennsylvania issued additional guidance on its "click-through" nexus policy on August 28, 2012, indicating that in-state online marketers would not create nexus for out-of-state sellers unless the online marketers are paid based on a percentage of actual sales.

II. Introduction – Nexus 101

What is nexus? *Nexus* is a Latin word that refers to "a means of connection; tie; link."[2] With respect to state and local taxes, and for purposes of this paper, nexus means contacts with a state or other taxing jurisdiction such that a person[3] has to collect and remit sales and use taxes or pay any business activity[4] taxes imposed by that jurisdiction.

Why is nexus important? As a tax practitioner, knowing the rules related to nexus can allow you to help clients structure their operations to do business in a taxing jurisdiction to minimize or eliminate paying any business activity taxes or having to collect and remit sales and use taxes on any taxable goods or services they sell in a taxing jurisdiction. You can also help clients identify in advance when they have a tax responsibility and help make sure they are in compliance, instead of clients being surprised by the receipt of a nexus questionnaire, audit notice, or assessment. Overlooking these rules may cause clients to have tax obligations for many years that they did not anticipate or want.

How do you know if a person has nexus? The general rule is if a person has a physical presence in a taxing jurisdiction and is selling taxable items in that jurisdiction, the person has a responsibility to collect and remit sales and use tax on those items and is subject to paying any business activity taxes that are imposed in that jurisdiction. If the person has only an economic presence in the jurisdiction, the law has not yet settled on whether a person is responsible for paying business activity taxes. Without a physical presence, however, there is no obligation to collect and remit sales and use taxes.

This paper identifies and discusses some of the controlling authorities that establish the rules relating to nexus for business activity taxes and sales and use taxes as applied across the country. It also includes information about Texas law and Comptroller policy.

<u>Practice Pointer:</u> It is not possible to include in this paper all relevant cases or authorities that apply to all situations relating to nexus issues. Each situation will require due diligence to determine all relevant facts

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[1] In accordance with IRS Circular 230, this communication does not reach a conclusion at a confidence level of at least more likely than not with respect to one or more significant Federal tax issues discussed herein, and with respect to such tax issues, this communication was not written, and cannot be used by you, for the purpose of avoiding Federal tax penalties that could be asserted against you.

[2] Random House Unabridged Dictionary, © Random House, Inc. 2006.

[3] In the context of this paper, the term "person" includes any taxable entity, whether it be an individual, a corporation, a partnership or some other form of legal entity. In most cases, the law treats each "person" or "legal entity" as a separate taxpayer for state tax purposes. This creates potential liability when an individual transacts with his business or when related or unrelated entities engage in transactions with each other.

[4] Business activity taxes include corporate income taxes and modified gross receipts taxes that are imposed on a person for the privilege of doing business in a state, such as the Texas franchise tax.

and the authorities that are applicable to the relevant taxing jurisdiction. Note that nexus inquiries tend to be very fact intensive.

III. Controlling Authorities

A. The United States Constitution – Due process and the commerce clause

State and local taxing jurisdictions have limited authority to impose tax obligations. The United States Constitution limits the states' power to impose tax beyond their borders. State and local tax statutes and regulations are subject to challenge if they conflict with the Constitution, federal statutes developed under the Constitution, or United States Supreme Court case law interpreting the Constitution. Moreover, several state constitutional provisions restrict taxing authorities' and state legislatures' power to impose tax obligations on persons.

The primary federal Constitutional provisions affecting state and local taxation authority and nexus issues are the due process clause and the commerce clause. The due process clause of the Fourteenth amendment grants a person due process of law. Some believe that we will see more due process challenges to state and local taxes in the future, particularly with respect to business activity taxes, given that the physical presence standard for such taxes is, per some court decisions, no longer a physical presence standard.[5]

The commerce clause grants to Congress the power "[t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."[6] A state or local taxing jurisdiction violates this provision when it discriminates against foreign commerce. Discrimination arises when a state or local taxing jurisdiction imposes greater requirements on foreign commerce than on in-jurisdiction commerce. In this context, "foreign" commerce may be activity engaged in either outside the United States or merely outside the taxing jurisdiction.

The Constitution also prohibits states from taxing exports. Article I, §9 of the Constitution states that "[n]o tax or duty shall be laid on articles exported from any state." Article I, §10 of the Constitution states that "[n]o state shall, without the consent of the Congress, lay any imposts or duties on imports or exports, except what may be absolutely necessary for executing its inspection laws: and the net produce of all duties and imposts, laid by any state on imports or exports, shall be for the use of the Treasury of the United States; and all such laws shall be subject to the revision and control of the Congress."

B. Supreme Court[7] Cases – *Quill*

The current federal test for constitutionality under the commerce clause, sometimes referred to as the dormant commerce clause, arises from the rules established in *Complete Auto Transit v. Brady*[8] in which the Supreme Court determined that a state or local tax is constitutional as long as:

(1) the tax applies to an activity that has a substantial *nexus* with the taxing state;

(2) the tax burden is fairly apportioned among various states where the entity conducts business;

(3) the tax does not discriminate against interstate commerce; and

(4) the tax paid fairly relates to the services the taxing state provides.

This paper deals solely with the first part of the *Complete Auto* test, whether substantial nexus exists as applied to business activity and sales and use taxes. More specifically, at the heart of this nexus discussion regarding sales and use taxes is the question of the extent to which a taxing jurisdiction can impose on

[5] *See, e.g.*, "Has the Due Process Clause Gotten Its Groove Back?" 64 State Tax Notes 721 (June 4, 2012).
[6] U.S. CONST., art. I, § 8, cl. 3.

[7] Unless otherwise noted, all references to "Supreme Court" mean the United States Supreme Court.
[8] 430 U.S. 274, 288 (1977).

sellers located inside and outside the jurisdiction a responsibility to be collection agents for the taxing jurisdiction. As noted in Section VIII of the paper, some states have considered ways to address the physical presence standard by putting into law reporting requirements for out-of-state sellers. The constitutionality of those laws is in question.

Practice Pointer – Use Tax 101: Before going any further, we need to explain that use taxes are complimentary to sales taxes. They are enacted to level the playing field so that regardless of whether a taxable item is purchased in the taxing jurisdiction and used there or purchased outside the jurisdiction and brought into it for use, tax is due.[9] Imposing use taxes is constitutional.[10] Unfortunately, many people are unaware that use taxes exist, let alone that they are legally due. As states continue to increase their use of public records, such as customs documents, FAA registries, and other available records, use tax audits and assessments increase. However, enforcing out-of-state entities' use tax collection responsibilities continues to be an important part of enforcing state tax laws. Therefore, many state taxing authorities have offices in other states to engage in those assessment and enforcement activities.

The 1992 case of *Quill v. North Dakota,*[11] led the Court to explain the interplay between the commerce clause and the due process clause. The *Quill* case establishes one of the key authorities for nexus determinations. In particular, *Quill* establishes the constitutional foundation for determining nexus for sales and use tax collection responsibilities.

Quill was a use tax case involving an office supply distributor from Illinois.[12] Quill sent catalogs to prospective customers throughout the country, including North Dakota. The catalogs solicited orders for sales of office supplies and equipment. Quill did not have any offices, warehouses, or storefronts in North Dakota.[13] None of its employees worked or resided there. Quill did not send any traveling salesmen or technicians into North Dakota. It solicited its business solely through catalogs, flyers, ads in national periodicals, and telephone calls. It made its deliveries to North Dakota customers from out-of-state locations by common carrier.[14] Quill did have some personal property in the state in the form of a few computer disks that it provided to certain purchasers to allow for ease in ordering.[15]

Even though Quill's contact with North Dakota was limited, it was the sixth largest supplier of office products in the state. It had 3,000 customers in the state who purchased almost $1 million worth of office supplies each year.[16] In other words, Quill's physical presence was arguably insignificant – virtually nonexistent – while its economic presence was comparatively significant.

Based on the above facts, North Dakota sought to impose on Quill an obligation to collect and remit use tax on its sales into North Dakota. Quill filed suit, challenging the tax under the due process clause and the commerce clause. Under the due process clause, the Court determined that Quill had sufficient contacts with the state because the company had purposely availed itself of benefits of the economic markets of the state.[17] Ultimately, the Supreme Court held that the state's imposition of a tax collection obligation on Quill violated the commerce clause because Quill had insufficient *nexus* with the state.[18]

Overall, the settled nexus rule we have from *Quill* is that if contacts with the taxing jurisdiction consist of solicitation of sales through catalogs, fliers, and similar items, and delivery of any items sold are solely through common carrier or the mail, then there is insufficient contact for substantial nexus to exist and

[9] *See, e.g.,* Texas Tax Code § 151.101 (Use Tax Imposed). All citations to Texas Tax Code § xxx are to Tex. Tax Code Ann. § xxx (Vernon 2008) unless otherwise noted.
[10] *See Henneford v. Silas Mason Co.*, 300 U.S. 577 (1937).
[11] 504 U.S. 298 (1992).
[12] *Id* at 302.
[13] *Id.*
[14] *Id.*
[15] *Id. at 314* (FN 8).
[16] *Id*. at 502.
[17] *Id.* at 307.
[18] *Id.* at 316-317.

Back to Table of Contents

the seller has no responsibility to collect and remit use tax on those sales.

C. Federal Statutes – P.L. 86-272

1. The general rule

The supremacy clause of the United States Constitution provides that state laws may not conflict with federal law, and when they do, federal law prevails.[19] One key federal statute governs a state's authority to impose a state income tax. This statute does not apply to sales and use tax. Therefore, a business may be responsible for collecting and remitting sales and use tax from customers within the taxing state even if it is not required to pay income tax there.

In 1959, the United States Congress enacted Public Law 86-272 to promote free trade among the states and to protect businesses from state-imposed burdens on interstate commerce.[20] Congress enacted Public Law 86-272 in response to a series of cases, beginning with *Northwestern States Portland Cement Co. v. Minnesota*,[21] in which the Supreme Court expanded the concept of nexus to allow states to impose tax on out-of-state businesses engaging in solicitation activities. In *Portland Cement*, salesmen shared a three-room office in Minnesota from which they solicited orders for sales of tangible personal property, which were approved and fulfilled from outside the state.[22] The Court determined that the regular and systematic presence of the sales force in the taxing state was sufficient to establish constitutional nexus there and held that the state could impose its income tax, so long as it was fairly apportioned.[23] In response to these cases, and in order to protect what the legislature viewed as the fundamental right to solicit orders out-of-state without fear of state taxation, Congress enacted Public Law 86-272.

Although Public Law 86-272 was intended to be a temporary measure when passed in 1959, it remains law. It prohibits a state from imposing an income tax on out-of-state entities that limit their activities in the state to solicitation of orders for sales of tangible personal property. Public Law 86-272 applies to "any tax imposed on, or measured by, net income."[24]

Public Law 86-272 directs that "no state … shall have power to impose … a *net income tax* on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following: … (1) the solicitation of orders … for sales of tangible personal property, which orders are sent outside the state for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and (2) the solicitation of orders … in the name of or for the benefit of a prospective customer … ." (Emphasis added).[25]

<u>Practice Pointer:</u> Be mindful that P.L. 86-272 only applies to business activity taxes when they are in the form of an income tax, which is the case in the majority of states. Whether the Texas franchise tax is an income tax to which P.L. 86-272 applies has been a point of contention, but so far no court has directly considered the issue. And, be mindful that P.L. 86-272 only applies to sales of tangible personal property and not to sales of services or intangibles.

2. De minimis contacts under P.L. 86-272 - A little nexus may be "okey dokey" when doing the P.L. 86-272 "hokey pokey"

In determining whether a particular business is subject to a net income tax, a court may disregard certain *de minimis* contact with the state. The *de minimis* contact which is ancillary to solicitation of

[19] U.S. CONST., Art. VI.
[20] Pub. L. No. 86-272 Title I, § 101, Sept. 14, 1959, 73 Stat. 555 (codified in 15 U.S.C. § 381, *et. seq.*).
[21] 358 U.S. 450, 454 (1959).
[22] *Id*.
[23] *Id*. at 469.
[24] 15 U.S.C. § 381(a).
[25] *Id*.

orders for sales of tangible personal property, such as performing a certain level of customer contact in order to facilitate solicitation, does not on its own create nexus.

In *Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co.*,[26] the Supreme Court considered whether the activities of a gum salesman traveling to Wisconsin were sufficient to create nexus for purposes of the state's net income tax. The Court applied the concept of *de minimis* activities in the context of state taxes, stating that "the venerable maxim *de minimis non curat lex* ("the law cares not for trifles") is part of the established background of legal principles against which all enactments are adopted, and which all enactments (absent contrary indication) are deemed to accept."[27]

The *Wrigley* case involved the Wisconsin franchise tax. Wrigley's contacts with the state were substantial in that Wrigley engaged in regular systematic activities in the state that were independent of soliciting sales, such as restocking stale gum and providing merchandise to retailers, so the company was subject to the tax. However, the Court acknowledged that a *de minimis* exception applies for purposes of determining whether state taxes violate Public Law 86-272. The Court stated that, "[w]hether a particular activity is a *de minimis* deviation from a prescribed standard [Public Law 86-272] … depends upon whether that activity establishes nontrivial additional connection with the taxing State."[28]

In the case of *INOVA Diagnostics v. Strayhorn,*[29] the Texas courts considered whether the presence of a single employee performing solicitation activities in Texas was sufficient to establish Texas franchise tax nexus. The case was decided under the Texas franchise tax that applied to returns filed prior to January 1, 2008, which was calculated on a combined tax based of earned surplus and taxable capital. The court determined that the earned surplus component was a tax imposed on, or measured by, net income, for purposes of Public Law 86-272, but the taxable capital component was not.[30] The court upheld the Comptroller's assessment on the basis that the solicitation activities were sufficient to establish nexus for the taxable capital component but not earned surplus.

The more recent Texas case of *Gallend Henning Nopak, Inc. v. Combs,*[31] also decided under the same version of the franchise tax as *INOVA Diagnostics*, considered whether a Wisconsin corporation was responsible for paying Texas franchise tax due to the contacts of its one Texas-based employee. The corporation had been filing employee wage reports for its Texas employee, which initiated the audit. The employee was a regional manager, which serviced distributors' needs in seven and a half (7½) states, including Texas. The corporation contended the presence of a single employee was insufficient to establish nexus within the taxing state. However, the Court determined that the employee's physical presence here went beyond a *de minimis* presence and was sufficient to establish nexus for Texas franchise tax purposes. The Court acknowledged that the employee's "primary job was investigating, handling, or otherwise assisting in resolving customer complaints,"[32] and determined that "[a]n activity regularly conducted within Texas pursuant to a company policy or on a continual basis shall normally not be considered trivial."[33]

Other state courts have acknowledged the concept of *de minimis* contact. For example, in *Asher, Inc. v. Director, Division of Taxation*, 22 N.J. Tax. 582 (January 5, 2006), the New Jersey Tax Court determined that a Pennsylvania candy manufacturer was subject to the corporate business tax because the delivery drivers' activities went beyond *de minimis* contact. Specifically, the delivery drivers picked up

[26] 505 U.S. 214 (1992).
[27] *Wrigley*, 505 U.S. at 231.
[28] *Id.* at 191.
[29] 166 S.W.3d 394 (Tex. App. – Austin 2005, pet. denied).
[30] *See id.* at 401.
[31] 317 S.W.3d 841 (Tex. App. – Amarillo, 2010, no pet.).
[32] *Id*. at 845.
[33] *Id*.

Back to Table of Contents

damaged or returned goods and collected delinquent accounts. These activities are not solicitation activities, so they are not protected under Public Law 86-272. They also are not ancillary to solicitation. The Tax Court determined they were too substantial to be characterized as *de minimis*.

The courts have also determined that a state may not define nexus in a way that extends beyond the limits of Public Law 86-272. In *National Private Truck Council, Inc. v. Commissioner*,[34] the Massachusetts Supreme Court determined that a Massachusetts regulation impermissibly reduced the tax immunity afforded under Public Law 86-272 because it required items to be shipped by common carrier or contract carrier from a point outside the state.

In *Indiana v. Kimberly-Clarke Corporation*,[35] the Supreme Court of Indiana held that a paper company was not "doing business" in the state, even though it had salesmen who lived in the state, drove company cars, carried display materials, took orders, verified the destruction of damaged merchandise, and coordinated delivery of merchandise for special orders.

In *Gillette Co. v. State Tax Commission*,[36] the Supreme Court of New York determined that New York overstepped Constitutional limits by imposing a corporate franchise tax on an out-of-state corporation that sent salesmen into the state to solicit orders. The salesmen performed various tasks within the state of New York. In particular, the New York taxing authority challenged Gillette's immunity from taxation in the state because salesmen made "indirect" or "merchandising" visits, during which they reviewed retailers' displays of merchandise to ensure that they were attractively arranged in a way that would promote sales.[37]

In *U.S. Tobacco v. Commonwealth*,[38] the Supreme Court of Pennsylvania determined that Pennsylvania did not have the power to impose its corporate income tax on an out-of-state corporation that had ten missionary representatives in Pennsylvania who drove throughout the state in company-owned cars to deliver samples of products, inform customers and potential customers about activities and promotions, and to take orders for the company's products. Although the *U.S. Tobacco* court made its decision based on the federal statute, it also discussed the long history of protecting solicitation activities:

> When a foreign corporation's contacts within the state fall below a certain minimal level, however, a state may not constitutionally exact a tax on those activities. As early as 1887, the Supreme Court held that an out-of-state business could send employees ("drummers") into another state to solicit sales, and if no other activities were involved, no taxable nexus was established.[39]

Similarly, in *Schering-Plough Healthcare Products Sales Corp. v. Commissioner*,[40] a Pennsylvania court determined that the state improperly narrowed the Public Law 86-272 exemption when it disallowed the exemption for taxpayers who did not directly own the items that they solicited within the state. The court determined that by "adding a condition not contemplated in the statute" the state exceeded its constitutional authority.[41]

IV. "Accidental" Nexus – What happens if you unknowingly step into it?

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[34] 688 N.E.2d 936 (Mass. 1997). *See also Commonwealth v. National Private Truck Council*, 480 S.E.2d 500 (Va. 1997) (holding invalid a similar Virginia regulation requiring shipment by common carrier).
[35] 416 N.E.2d 1264 (Ind. 1981).
[36] 56 A.D.2d 476 (N.Y. App. Div. 1997).

[37] *Id*. at 478.
[38] 386 A.2d 471 (Pa. 1978).
[39] *Id*. at 133. (citations omitted).
[40] 805 A.2d 1284 (Pa. Commonw. Ct. 2002).
[41] *Id*.

In this section of the paper, we identify some of the trigger points and main problem areas for taxpayers both as to business activity taxes and sales and use taxes.

Practice Pointer: If a client comes to you seeking advice BEFORE it has heard from a department of revenue and you determine that the client has exposure to a potential liability for unpaid or uncollected taxes, look at the applicable state's laws and department of revenue policies concerning Voluntary Disclosure Agreements.[42] The Multistate Tax Commission also runs a VDA program if a taxpayer has exposure in more than one state.[43] In addition, states will at times have amnesty programs which can be a way to limit liability while either putting things in order for future compliance, or making necessary changes to business practices to avoid any future liability. Note that Texas currently has an amnesty program in place through August 17, 2012,[44] in addition to its standard voluntary compliance program.[45]

A. Battling standards for business activity taxes: physical presence or economic presence?

Despite the nexus boundaries established by *Quill* and Public Law 86-272, it can be very easy for a person to overstep these boundaries and accidentally create nexus within another state or taxing jurisdiction.

As technology allows businesses to create a strong virtual presence and substantial economic presence without any physical presence, taxpayers, tax administrators, the courts, and Congress are grappling with what *Quill* means for business activity taxes. Namely, the big question everyone wants answered is whether a substantial economic presence is enough to allow states to impose business activity taxes or whether a physical presence required.

While *Quill* left no question as to the standard for imposing sales and use tax collection responsibilities – a physical presence is required – there is great and passionate debate as to whether *Quill* established the same standard for business activity taxes. Some have called the economic presence standard "utter nonsense" and any attempts to enforce it "simply illegitimate."[46]

The debate rests, in part, on this statement in *Quill*:

> Although we have not, in or review of other types of taxes, articulated the same physical presence requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule."[47]

The *Bellas Hess* rule referred to by the *Quill* court was a bright line test first stated by the Court that there needed to be a physical presence in a state for use tax responsibilities to apply.[48]

Much to the chagrin of states and taxpayers alike, the Supreme Court has denied review to a number of state nexus cases, which have concluded that physical presence is not the standard that determines if a state may impose business activity taxes. In 2011, the Supreme Court declined to hear cases decided by the Iowa and Washington State Supreme Courts, the *KFC* and *Lamtec* cases, *infra,* which both held that no physical presence was needed in a state for a business activity tax to be imposed.

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[42] *See, e.g.,* information about the Texas VDA program at www.window.state.tx.us/taxinfo/taxpubs/tx96_576.html.
[43] *See* www.mtc.gov/nexus.
[44] *See* www.freshstart.texas.gov.
[45] Information available online at: http://www.window.state.tx.us/taxinfo/taxpubs/tx96_576.html

[46] *See* "An Apology Revisited: Intercompany Licensing of Intangibles in an Age of Tax Amnesties, Capitulation, and Judicial Confusion" by Donald M. Griswold and Sara A. Lima, Tax Management, Multistate Tax Report, Vol.15, No. 4, April 25, 2008.
[47] *Quill*, 504 U.S. at 314.
[48] *See National Bellas Hess, Inc. v. Dep't of Revenue*, 386 U.S. 753 (1967).

Back to Table of Contents

In *KFC v. Iowa Department of Revenue*,[49], the issue presented to the Supreme Court was "[w]hether a franchisor without physical presence in the state can be made to pay tax on income derived from granting franchises in the state or whether this violates the Commerce Clause."[50] The Iowa Supreme Court held that intangibles KFC's franchisees used in Iowa established a sufficient connection to establish nexus there and subject KFC to Iowa's income tax.[51] The dormant commerce clause did not require a separate physical presence by the out-of-state corporate taxpayer.[52]

In *Lamtec Corp. v. Washington Department of Revenue*[53], an out-of-state taxpayer, which had no offices or agents permanently in Washington but frequently sent representatives there to visit customers, was determined to have sufficient presence within the state to be subject to Washington's business and occupations (B&O) tax.[54] The Washington B&O tax is a gross receipts tax imposed on businesses with substantial nexus for the privilege of doing business in the state.[55] Lamtec argued that it did not have a "physical presence" in the state because it didn't have a "brick and mortar" or "established sales force" in Washington.[56] However, the Court determined its regular systematic contacts with the state were "significantly associated with the taxpayer's ability to establish and maintain' its market," and were therefore sufficient to establish a physical presence and a tax responsibility.[57] A 2012 ruling by the Washington Department of Revenue determined that an out-of-state seller's two visits to a buyer in Washington were unassociated with its ability to establish a market there, but were instead directly related to its wholesale sales of goods to the buyer and therefore did not establish nexus for purposes of the B&O tax.[58] The visits were made by the taxpayer's national sales director to meet with an assistant buyer of the retailer.

Here are two more examples of cases where state courts have held that no physical presence is required. In *Quotron Systems v. Limbach*, 62 Ohio St. 3d 447 (1992), the Supreme Court of Ohio determined that Ohio could impose its tax on fees for stock quotes that were received by Ohio customers using their own equipment from a New York company that performed services in New York. In the case of *Steager v. MBNA America Bank*, 640 S.E.2d 226 (2006), *cert denied*, 551 U.S. 1141 (June 18, 2007), the West Virginia Supreme Court upheld the imposition of corporate net income tax on a Delaware domiciled bank that provided credit card services to West Virginia customers.

More recently, the West Virginia Supreme Court considered whether ConAgra Brands' licensing transactions constituted doing business in the state.[59] ConAgra Foods, Inc. established ConAgra Brands in 1997, in order to centralize management and protection of its trademarks and trade names. ConAgra Foods and its affiliates transferred the intellectual property to ConAgra Brands and began paying substantial royalties for use of the trade marks and trade names.[60] The products bearing the trade names were sold throughout the United States, including West Virginia. However, ConAgra Brands did not own or rent any offices warehouses or other facilities in West Virginia; nor did it maintain any inventory, have employees or agents, or sell or

[49] ___ S.Ct. ___, 2011 WL 4530160 (Mem), 80 USLW 3017 (cert. denied October 3, 2011).
[50] *See* U.S. Supreme Court, Docket No. 10-1340, petition for certiorari filed April 28, 2011).
[51] ___ S.Ct. ___, 2011 WL 4530160 (Mem), 80 USLW 3017 (cert. denied October 3, 2011).
[52] *Id*.
[53] ___ S.Ct. ___, 2011 WL 4530146 (U.S.) (cert. denied October 3, 2011),
[54] *Id*. at ¶ 1.
[55] *Id*. at ¶ 5.
[56] *Id*. at ¶ 8.
[57] *Lamtec* at ¶ 16.

[58] Washington Tax Determination No. 11-0225 (issued 6/28/2012).
[59] *Griffith v. ConAgra Brands, Inc.,* No. 11-0252 (W. Virginia Sup. Ct. May 24, 2012).
[60] For example, "Armour, Butterball, Country Skillet, Healthy Choice, Kid Cuisine, Morton, Swift and Swift Premium." Four principal licenses made between $19,269,000 and $46,247,000 in sales in West Virginia, earning royalties of approximately $1,156,000.

distribute products in the state. The court concluded ConAgra Brands had not done business in West Virginia because neither the supplying of ingredients or labels by third parties for the products nor the licensing by ConAgra Brands had any association with West Virginia sufficient to impose the assessments because all the licensees' manufacturing activities occurred outside West Virginia and none of the licensees operated any retail stores in West Virginia. In doing so, the court upheld its position in *MBNA* that the significant economic presence test is a better indicator of substantial nexus, but distinguished the cases because ConAgra didn't engage the solicitation activities as MBNA had. Moreover, ConAgra was not a shell corporation created solely for tax avoidance purposes because it performed the function of managing the intellectual property portfolio. As a result, there was no "purposeful direction" under the due process clause and no "significant economic presence" under the commerce clause, so the business lacked sufficient nexus with the taxing jurisdiction.

Overall, only two states are considered to specifically require a physical presence before a business activity tax is owed and both rules are based on court case outcomes. They are Texas[61] and Tennessee.[62]

Other states have imposed economic nexus standards by statute or rule. For example, a 2010 decision by the Ohio Department of Taxation determined that L.L. Bean, Inc. was subject to the Commercial Activity Tax (CAT) due to substantial nexus.[63] The State of Ohio determined the taxpayer had substantial nexus because its annual taxable gross receipts exceeded $500,000 in Ohio. The case has been appealed. The CAT is an annual tax imposed on the privilege of doing business in Ohio, measured by gross receipts from business activities in Ohio.[64] Businesses with Ohio taxable gross receipts of $150,000 or more per calendar year must register for the CAT, file all the applicable returns, and make all corresponding payments.[65] The Ohio Supreme Court has held that the CAT is not a sales tax.[66]

Effective August 15, 2011, the New Jersey Department of Revenue has adopted an amendment to its corporation business tax nexus regulation which is retroactive to 2002 and provides that a "financial business corporation, a banking corporation, a credit card company or similar business that has its commercial domicile in another state is subject to tax in [New Jersey] if during any year it obtains or solicits business or receives gross receipts from sources within [New Jersey.]"[67]

Effective April 30, 2010, the Colorado Department of Revenue (DOR) adopted rule amendments consistent with the Multistate Tax Commission's model "Factor Presence Nexus Standard for Business Activity Taxes."[68] The amendments address corporate income tax nexus based on the factor-presence nexus standard. An entity will be considered to have substantial nexus and will be treated as doing business in Colorado when it exceeds any of the following thresholds:

- $50,000 of property;
- $50,000 of payroll;
- $500,000 of sales; or
- 25% of total property, total payroll or total sales.

Moreover, the regulations include an anti-abuse provision allowing the DOR to combine the property, payroll or sales of two or more entities within a combined group if the DOR determines they've been

[61] *See Bandag*, *infra* Section V. C.3.; *INOVA Diagnostics*, *supra* at Section III.C.2.; and *Gallend Henning Nopak, supra* at Section III.C.2.
[62] *See Am. Online, Inc. v. Johnson*, No. M2001-00927-COA-R3-CV, 2002 Tenn. App. LEXIS 555, 2002 WL 1751434, at *2 (Tenn. Ct. App. July 30, 2002).
[63] *See In re L.L. Bean, Inc.*, Ohio Department of Taxation, No. 000000198 (Aug. 10, 2010).
[64] Ohio Revised Code, Title LVII Taxation § 5701.01 *et seq*.
[65] *Id*.
[66] *See Ohio Grocers Assn. v. Levin*, 123 Ohio St.3d 303 (2009-Ohio-4872).
[67] N.J.A.C. 18:7-1.8.
[68] Available at www.mtc.gov.

manipulated in order to artificially fall below the *de minimis* thresholds.[69] The regulations also provide definitions, solicitations requirements, information on how to rebut the presumption, notice requirements, and penalties for failure to properly notify purchasers.[70]

B. Allocation and Apportionment Formulas for Business Activity Taxes

Differing allocation and apportionment formulas amongst the states may result in attribution of certain out-of-state income to the state imposing the tax. Courts have compared multi-factor apportionment formulas with single-factor formulas in determining whether they unfairly attribute sales to in-state activities.[71] In addition, courts have reviewed throwback provisions that treat certain out-of-state sales as in-state sales where a business does not have sufficient nexus in the other state in order for it to impose its tax.[72]

As a general rule, a state "may not tax 'nonunitary' income received by a nondomaciliary corporation from an 'unrelated business activity.'"[73] In the case of *Hunt-Wesson v. the Franchise Tax Board of California*,[74] the Supreme Court determined that California wrongfully disallowed interest expense to a multistate corporation to the extent the amount exceeded certain out-of-state income arising from the unrelated business activity of a discrete business enterprise.

The unitary business principle is said to do a "better job of accounting for 'the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise' than, for example, geographical or transactional accounting."[75]

Jurisdictions that impose unitary taxation and combined reporting subject entities to taxation even though they may not, on a stand-alone basis, have a sufficient connection with the state for it to impose its tax. Under unitary taxation and combined reporting a business entity may be subject to tax even if it does not have people or property at any time during a tax period. The taxing responsibility arises due to the affiliation of one entity with other entities in a unitary combined group. Most state taxing authorities impose a standard that requires a certain degree of common ownership, or affiliation, plus other factors which tend to show that an in-state entity derives some tangible or intangible benefit from its affiliation with the other entities in the combined group. The three primary factors, in addition to common ownership, for determining whether a unitary business exists are:

(1) whether the entities are in the same line of business;

(2) whether they are vertically integrated; and

(3) whether they are functionally integrated through strong centralized management.

The case of *MeadWestvaco Corp. v. Illinois Dept. of Revenue*, 553 U.S. 16 (2008), affirmed that the three factors for ascertaining whether there should be a unitary business, particularly when the asset of a business is another business, are functional integration, centralized management and economies of scale. The Supreme Court clarified that its language regarding "operational purpose" should not be interpreted as an additional ground for apportionment.

The case in chief considered whether Illinois could constitutionally tax an apportioned share of the capital gain arising from an out-of-state corporation's sale of one of its business divisions. Mead, an Ohio

[69] Colorado Department of Revenue Reg. 39-22-301.1 .
[70] *Id*.
[71] *See, e.g.*, *Container Corp. of America v. California*, 463 U.S. 159 (1983).
[72] *See, e.g.*, *Home Interiors & Gifts, Inc. v. Strayhorn*, 175 S.W.3d 856 (Tex. App.--Austin 2005, pet. denied).
[73] *Hunt-Wesson v. Franchise Tax Bd. of Cal*, 528 U.S. 458 (2000).
[74] *Id*.
[75] *Allied-Signal, Inc. v. New Jersey*, 504 U.S. 768, 783 (1992).

corporation formed in 1864, was in the business of producing and selling paper, packaging and school and office supplies. Mead also owned an electronic research service, Lexis, which it had purchased in 1968 and sold in 1994. Mead did not report any of the gain from the sale on its Illinois business tax returns because it considered the proceeds to be nonbusiness income unrelated to the unitary business of Mead. The Illinois Department of Revenue audited Mead and assessed tax on the income from the sale of the electronic research service.

The Supreme Court evaluated whether Lexis was part of Mead's unitary business. Lexis had been a wholly owned subsidiary until 1980, when it merged into Mead. Lexis was subject to Mead's general oversight but a separate management team in Illinois directed its day to day business activities. Lexis and Mead maintained separate manufacturing, sales, and distribution facilities, as well as separate accounting, legal, human resources, credit and collections, purchasing, and marketing departments. Neither business was required to purchase goods or services from the other, nor did they receive discounts on purchases. In fact, Lexis purchased most of its paper from other suppliers, and neither entity was a significant customer of the other. Mead generally limited its involvement to approving Lexis' annual business plan and reviewing any significant corporate transactions (such as capital expenditures, financings, mergers and acquisitions, or joint ventures).

The trial court reasoned that Lexis and Mead could not be unitary because they were not functionally integrated or centrally managed and enjoyed no economies of scale; nonetheless, the trial court required apportionment of the sale proceeds to Illinois because Lexis served an "operational purpose" in Mead's business, particularly in the allocation of resources. The appellate court affirmed. The Supreme Court vacated the appellate court's decision, stating that the Court did not intend for its language regarding "operational purpose" to establish yet another means of identifying a unitary business. The Court remanded the case to the appellate court for further review and declined to rule on whether the businesses were unitary.

<u>Practice Pointer:</u> Texas required combined reporting for the first time as part of the revised franchise tax that applies to returns filed on or after January 1, 2008 under the new margin calculation. There are no Texas cases decided on this issue.

C. Intangibles and Business Activity Taxes

In *Lanco, Inc. v. New Jersey*, 908 A.2d 176 (2006), c*ert denied*, 551 U.S. 1131 (June 18, 2007), the state of New Jersey imposed tax on a Delaware corporation that licensed property to its affiliate Layne Bryant. Although the Delaware corporation had no physical presence in New Jersey and had no employees or property there, the Court determined that the affiliate's use of its intellectual property in the state was sufficient to create taxing nexus. The court considered the affiliate's physical presence in the state sufficient to impose tax on the owner of the intellectual property.[76]

D. Disregarded Entities and Business Activity Taxes

A taxpayer may establish nexus by owning a disregarded entity doing business within a state.

In a recent legal ruling, the California Franchise Tax Board took the position that being the sole owner of a disregarded entity "doing business" in California was enough to create substantial nexus for the owner, despite the owner having no separate activities in the state.[77] The reasoning behind the decision was that California law conforms to federal classification of business entities; thus, since federal tax statutes disregard an entity it would also be disregarded for California purposes. When an entity is disregarded for tax purposes, the disregarded entities activities are

[76] *See also Geoffrey, Inc. v. Comm'r of Revenue*, No. C271816, (Mass. App. Tax. Bd. July 24, 2007).
[77] CA FTB Legal Ruling 2011-01 (Jan. 11, 2011).

treated as the activities of its owner. If the disregarded entities activities in the state create substantial nexus the owner would have substantial nexus, allowing California to tax the owner of the disregarded entity because of the subsidiaries activities.

E. Representatives and Sales & Use Taxes

A person may establish nexus by having other persons act on its behalf within a taxing jurisdiction and therefore trigger a responsibility to collect and remit use taxes.

In cases that turn on whether substantial nexus is established for a seller of items by the presence of representatives acting on the seller's behalf in a taxing jurisdiction, we have learned from the Supreme Court in the *Tyler Pipe* decision that "the crucial factor governing nexus is whether the activities performed in the [jurisdiction] on behalf of a taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in [the jurisdiction] for the sales."[78]

In addition to *Tyler Pipe*, we have the longstanding rule from another Supreme Court decision, *Scripto, Inc. v. Carson,* that the characterization of the persons who are present in the taxing jurisdiction is of no significance whether they are called agents, representatives, independent contractors, or something else.[79]

For example, in the case of *Cruise Intermodal Corp. v. Commonwealth*, Pennsylvania Commonwealth Court Dkt., No. 667 F.R. 2004 (January 18, 2007), the court considered whether an out-of-state broker established taxing nexus by hiring independent truck drivers to deliver goods into the state of Pennsylvania. Cruise Intermodal had no employees or office located in Pennsylvania. However, it did lease the trucks from the independent owners in order to make the deliveries into the state. The court determined that the leases created a sufficient physical presence for Pennsylvania to impose tax collection responsibilities on Cruise Intermodal.

In the case of *Dell Catalog Sales L.P. v. Taxation and Revenue Dep't*,[80] the court held that Dell established substantial nexus in New Mexico through the activities of a third party, BancTec, which provided warranty services to repair computers Dell sold to New Mexico residents. Relying on the nexus rules established in *Tyler Pipe* and *Scripto*, the court found it significant that 75 percent of Dell's New Mexico customers purchased the additional service contract, which helped it create and maintain a market for its computers in New Mexico, that BancTec was required by its contract with Dell to represent Dell in a professional manner, and that BancTec made over 1,200 service visits during the audit period in question.

This decision contrasts one from Kansas in which the court determined there were insufficient contacts with the state to impose use tax collection responsibilities when an out-of-state seller sent technicians into Kansas an average of three times per year to perform services on the items sold.[81] The *Intercard* case considered the tax collection responsibilities of a company that manufactured and sold electronic data cards and card readers to customers throughout the U.S., including Kansas. At the request of Kinko's, one of its largest customers, Intercard's employees made 11 visits to Kansas during the audit period to provide technical installation services.[82] The State of Kansas determined that these 11 visits created nexus and declared that Intercard was doing business in the state.[83] The Kansas Board of Tax Appeals reversed the assessment determining the 11 visits did not "transcend the slight physical test."[84]

[78] *Tyler Pipe Indus., Inc. v. Washington State Dep't of Revenue*, 483 U.S. 232, 250 (1987).
[79] 362 U.S. 207, 211 (1960).
[80] 199 P.3d 863 (N.M. Ct. App. 2008), *cert. denied* 129 S.Ct. 1616 (2009).
[81] *See In re Intercard, Inc*., 14 P.3d 1111 (Kan. 2000).
[82] *Id.*
[83] K.S.A. 79-3702(h).
[84] *Id.*

The Kansas Supreme Court affirmed, agreeing that the 11 visits Intercard's employees made to visit Kansas customers were isolated, sporadic, and insufficient to establish substantial nexus.[85]

Overall, it's important to note that state courts are divided on how the substantial nexus standard should be defined and applied in imposing tax collection obligations based on the seller's representatives being present in the taxing jurisdiction. A New York court defined the standard this way:

> While a physical presence of the vendor is required, it need not be substantial. Rather, it must be demonstrably more that a 'slightest presence' [citation omitted]. And it may be manifested by the presence in the taxing State of the vendor's property or the conduct of economic activities in the taxing State performed by the vendor's personnel or on its behalf.[86]

On the other hand, the *Intercard* court criticized the New York opinion for ignoring the *Quill* holding that sufficient physical presence is a necessary element of the nexus required for a state to impose a use tax collection duty.[87] The court stated:

> Economic presence cannot negate this requirement. The *Quill* Court was wholly unconcerned with any economic benefit resulting from the continuous physical presence of a "few floppy diskettes" in North Dakota. Rather, *Quill* affirmed the "bright line" rule of *Bellas Hess* that the commerce clause protects out-of-state vendors from the imposition of use tax requirements where those vendors have no physical presence in the taxing state. The *Quill* Court admitted that the bright line test appears artificial at its edges: 'Whether or not a State may compel a vendor to collect a sales or use tax may turn on the presence in the taxing State of a small sales force, plant, or office. [Citation omitted.] This artificiality, however, is more than offset by the benefits of a clear rule. Such a rule firmly establishes the boundaries of legitimate state authority to impose a duty to collect sales and use taxes and reduces litigation concerning those taxes. This benefit is important, for as we have so frequently noted, our law in this area is something of a 'quagmire' and the 'application of constitutional principles to specific state statutes leaves much room for controversy and confusion and little in the way of precise guides to States in the exercise of their indispensable power of taxation.' [Citation omitted.]" *Quill*, 504 U.S. at 315-16.'[88]

More recently, state courts have split with respect to the activities of teachers who are affiliated with a Missouri company called Scholastic Book Clubs, Inc., an out-of-state book distributor, or companies with similar business models, on the issue of whether the teachers' activities on behalf of the company created substantial nexus. The basic business model the company follows is that teachers in the state are sent catalogs and order forms which are distributed to students. The teachers receive orders and payments and forward those to Scholastic. The company then sends purchased materials via common carrier to the teachers for distribution. Scholastic otherwise has no physical presence in the state.

In Connecticut,[89] Tennessee,[90] California[91] and Kansas,[92] state courts have found that the teachers' activities created substantial nexus, although the legal reasoning is not consistent among the decisions. In

[85] *Id.*
[86] *Orvis Co. v. Tax Appeals Tribunal*, 654 N.E.2d 954, 960 (1995), *cert. denied* 516 U.S. 989 (1995).
[87] *See In re Intercard, Inc*., 14 P.3d 1111 (Kan. 2000).
[88] *Id*. at 359.
[89] *Scholastic Book Clubs, Inc. v. Comm'r of Revenue Servs.*, 38 A.3d 1183 (2012).
[90] *Scholastic Book Clubs, Inc. v. Farr*, 2012 Tenn. App. LEXIS 57, Jan. 27, 2012.
[91] *Scholastic Book Clubs, Inc. v. Board of Equalization*, 207 Cal. App. 3d 734, 255 Cal. Rptr. 77 (1989).
[92] *In re Scholastic Book Clubs, Inc*., 260 Kan. 528, 920 P.2d 947 (1996).

Back to Table of Contents

Arkansas,[93] Michigan,[94] and Ohio,[95] the states determined that nexus was not created, focusing in part on the fact that the teachers were not compensated in relation to their activities.

On June 26, 2012, Scholastic petitioned the U.S. Supreme Court to review the issue given the split of authorities in the states.[96] No company has litigated this issue in Texas courts, but the Comptroller has considered similar fact patterns and found that there was substantial nexus.[97]

In addition, the New Mexico Supreme Court has recently granted review of an April 2012 state court of appeals decision holding that Barnesandnoble.com has nexus with New Mexico based on its relationship with in-state Barnes & Noble bookstores. The court of appeals found that the use of trade names and trademarks by the in-state stores created goodwill for the online entity, which in turn created a substantial nexus in the state, along with the fact that, for example gift cards could be redeemed by both the in-state and online sellers.[98]

, As indicated by these cases, taxpayers continue to wade through a nexus "quagmire" where similar facts leads to different outcomes and states struggle to assess taxes in a manner that fairly represents the value the states provide without running afoul of constitutional requirements and boundaries.

V. Texas Authorities Concerning Nexus

The Texas Comptroller's office, like any other department of revenue, is constrained by federal authorities, as noted in Section III (Controlling Authorities) of this paper.

Practice Pointer: The Comptroller has a searchable database of rules, letters, hearing decisions, and court cases called "STAR" which stands for State Tax Automated Research. It is available at http://cpastar2.cpa.state.tx.us/index.html and is a good place to search for information on Texas nexus questions. Comptroller documents referenced in this paper are available on STAR.

A. State Use Tax

Section 151.107 of the Texas Tax Code titled "Retailer Engaged in Business in This State" controls whether an out-of-state vendor has an obligation to collect and remit use tax in the state. It expressly states in subsection (c) that federal law is controlling.

Comptroller Rule 3.286,[99] which provides additional guidance on Texas Tax Code § 151.107, closely follows the language of the above Tax Code provision and establishes sellers' and purchasers' responsibilities for sales and use taxes. The Comptroller considers a seller to be "engaged in business" where any of the following conditions exist:

- The seller maintains, occupies, or uses, permanently or temporarily, directly or indirectly, or through an agent, by whatever name called, an office, place of distribution, sales or sample room, warehouse or storage place, or other place of business;
- The seller has any representative, agent, salesperson, canvasser, or solicitor who operates in this state under the authority of the seller to sell, deliver, or take orders for any taxable items;
- The seller promotes a flea market, trade day, or other event that involves sales of taxable items;

[93] *Pledger v. Troll Book Clubs, Inc*., 316 Ark. 195, 871 S.W.2d 389 (1994).
[94] *Scholastic Book Clubs, Inc. v. Dept. of Treasury*, 223 Mich. App. 576, 567 N.W.2d 692 (1997).
[95] *Troll Book Clubs, Inc. v. Tracy*, Docket No. 92-Z-590, 1994 Ohio Tax LEXIS 1374 (Ohio Bd. Tax App. August 19, 1994).
[96] *See* "Scholastic Files Petition for Certiorari in Nexus Case," 65 State Tax Notes 94 (July 9, 2012).
[97] *See, e.g.,* Hearing No. 17,057 (STAR # 8609H0755E02, July 7, 1986).
[98] *See New Mexico Dept. of Revenue v. Barnesandnoble.com, LLC*, 2012 N.M. App. LEXIS 32 (Ct. of Appeals of New Mexico, Apr. 18, 2012).
[99] All references to Comptroller Rules are to 34 Tex. Admin. Code § x (West 2010).

- The seller uses independent salespersons to make direct sales of taxable items;
- The seller derives receipts from a rental or lease of tangible personal property that is located in this state;
- The seller allows a franchisee or licensee to operate under its trade name if the franchisee or licensee is required to collect Texas sales or use tax; or
- The seller conducts business in this state through employees, agents, or independent contractors.

As an example of agency policy, note that a Comptroller hearing decision determined that a California corporation that manufactured and sold desktop computers, workstations, and servers had nexus in Texas because it provided on-site warranty and service agreements for its computer hardware products through third parties located in Texas.[100]

The California corporation marketed its products through an Internet web page and a toll-free phone number.[101] The corporation did not send its own employees into Texas to perform the work, but contracted with third party contractors to provide the repairs.[102] The taxpayer contended the contracts with the third party service providers were insufficient to constitute "substantial nexus" under the requirements of *Quill*.[103] The Comptroller held that the presence of an independent contractor that accepts returned or defective merchandise on the California corporation's behalf was sufficient to establish an agency relationship.[104] Since the contractors were acting as the California corporation's agents in the State of Texas, the Comptroller required the California corporation to collect and remit sales and use tax on its sales to Texas customers.

The Texas Comptroller amended Rule 3.286(a)(2)(E) (effective July 11, 2010) to state:

A person is engaged in business in Texas if the person has nexus with the state as evidenced by, but not limited to, any of the following: …derives receipts from a rental or lease of tangible personal property that is located in this state <u>or owns or uses tangible personal property that is located in this state, including a computer server or software</u>.

In 2011, the Texas Legislature enacted House Bill 1841, which added Texas Tax Code § 151.108 (effective January 1, 2012), and which in part superseded the amendment to 3.286. This provision clarifies that a person whose only connection with this state is using "Internet hosting" services is not doing business in Texas. "Internet hosting" involves providing unrelated users Internet access to computer services using property the provider owns, leases and manages. The user may store or process the user's data or use software that the provider owns, licenses or leases. It does not include telecommunications services. Therefore, if an out-of-state seller of taxable items uses a Texas-based provider of Internet hosting services, and that is the seller's only connection with the state, then the seller has no obligation to collect and remit tax on those sales.

A bigger change to the state tax nexus requirements was enacted during the 2011 special session of the legislature as part of Senate Bill 1, Article 30. This provision modifies Texas Tax Code § 151.107 to state that an out-of-state entity establishes nexus when it "maintains, occupies, or uses in this state permanently, temporarily, directly or indirectly or through a subsidiary or agent by whatever name, an office, distribution center, sales or sample room or place, warehouse, storage place or any other physical location where business is conducted."[105]

The legislative revisions now include as doing business in Texas an entity that holds a substantial ownership interest in, or is owned in whole or

[100] *See* Hearing No. 41,140 (September 19, 2002).
[101] *Id*.
[102] *Id*.
[103] *Id*.
[104] *Id*.

[105] SB 1, Section 30.02, 82nd Legislature, First Special Session (2011).

substantial part by, a person who maintains a business location in Texas if:

- The retailer sells the same or substantially similar line of products under a business name that is the same as or substantially similar to the entity with nexus; or

- The facilities or employees of the entity with a location in Texas are used to:

  (1) advertise, promote or facilitate sales by the out-of-state retailer; or

  (2) perform any other activity of the retailer intended to establish or maintain a marketplace in Texas, such as receiving or exchanging returned merchandise.

They also include as "doing business in Texas" an entity that holds a substantial ownership interest in, or is owned in whole or substantial part by, a person who:

- Maintains a distribution center, warehouse or similar location in Texas; and

- Delivers property sold by the retailer to consumers.

The legislative changes define "ownership" to include: direct ownership, common ownership, and indirect ownership through a parent entity, subsidiary or affiliate. Ownership is treated as "substantial" if there is at least 50% ownership of the total combined voting power of all classes of stock for a corporation or the beneficial ownership of stock of the corporation. For trusts, the measure is at least 50% direct or indirect beneficial interest in the trust corpus or income. For LLCs, it is measured by at least 50% direct or indirect membership interest or beneficial interest. For other entities, such as partnerships or associations, the measure is at least 50% direct or indirect interest in the capital or profits of the entity.

B. Local Use Tax

Be mindful that Texas currently has almost 1,500 local jurisdictions with authority to impose sales and use taxes. They consist of cities; counties; special purpose districts, such as hospital districts, emergency services districts, and library districts; and transit authorities. Unless special sourcing rules apply, the physical presence rules that apply to any obligation to collect and remit sales and use tax at the state level by an out-of-state seller also apply to the obligation of an in-state seller who may have to collect and remit local sales and use taxes when making sales into local taxing jurisdictions.[106]

Practice Pointer: Currently, Comptroller Publication 94-105, Guidelines for Collecting Local Sales and Use Tax,[107] provides the most current and comprehensive information for understanding local tax collection responsibilities. Many Comptroller rules currently on file with the Texas Secretary of State regarding local taxes are out of date. The agency is currently working on a new rule that will combine all current rules, laws and policies relating to local taxes in one place. Note, however, many of the state sales tax rules in the Texas Administrative Code, Title 34, Part 1, Chapter 3, Subchapter O contain provisions related to local tax collection rules as applied to specific goods and services.

C. Texas Franchise Tax

Texas imposes the franchise tax on entities that are doing business in the state. Historically, this has included individual corporations and limited liability companies that conducted at least some portion of their operations in Texas. The margin calculation, effective for reports due on or after January 1, 2008, extends this to a long list of entities, including combined groups and has expanded the concept of "doing business" from a single-entity test to a combined group basis.

[106] *See, e.g.,* Comptroller Letter No. 200803162L (March 11, 2008)
[107] Available online at http://www.window.state.tx.us/taxinfo/taxpubs/tx94_105.pdf

Back to Table of Contents

However, for purposes of apportionment, and in particular when determining the amount of receipts to include in the numerator representing business done in Texas, the franchise tax still recognizes that only individual entities with substantial nexus are to be included. States that follow this method of apportionment are considered to follow the "Joyce" rule, which is based on a California court case by that name which first upheld that method of apportionment.

1. The General Rule

Texas statutory law defines "doing business" as broadly as it can without overstepping constitutional boundaries. The statute states: "The tax imposed under this chapter extends to the limits of the United States Constitution and the federal law adopted under the United States Constitution."[108] The franchise tax statute and the Comptroller's interpretation of the statute are subject to challenge if they conflict with the United States Constitution, federal statutes developed under the Constitution, or United States Supreme Court case law interpreting the Constitution. Moreover, several Texas constitutional provisions restrict the Comptroller's and Legislature's power with regard to the ability to impose tax on persons and businesses.

Based upon the Texas Legislature's position that out-of-state taxpayers are not entitled to Public Law 86-272 protections under the margin calculation,[109] the following types of activities will likely constitute "doing business in Texas" under the revised Texas franchise tax:[110]

Contracting:

- performing a contract in Texas, regardless of whether the taxable entity brings its own employees into the state, hires local labor, or subcontracts with another

Providing Services:

- providing any service in Texas, regardless of whether the employees, independent contractors, agents, or other representatives performing the services reside in Texas;
- maintaining or repairing property located in Texas whether under warranty or by separate contract; or
- installing, erecting, or modifying property in Texas;

Owning Inventory:

- having an inventory in Texas or having spot inventory for the convenient delivery to customers, even if the bulk of orders are filled from out of state;

Soliciting:

- having employees, independent contractors, agents, or other representatives in Texas, regardless of whether they reside in Texas, to promote or induce sales of the foreign entity's goods or services;

Maintaining a Place of Business:

- maintaining a store or other place of business in Texas;
- doing business in any area within Texas, even if the area is leased by, owned by, ceded to, or under the control of the federal government;

Real Estate Dealings:

- holding, acquiring, leasing, or disposing of any real property located in Texas;
- owning a royalty interest in an oil and gas well located in Texas;[111]

Performances:

[108] Texas Tax Code § 171.001.
[109] Section 21 of Acts 2006, 79th Leg., 3rd C.S., ch. 1 provides "The franchise tax imposed by Chapter 171, Tax Code, as amended by this Act, is not an income tax and Pub. L. No. 86-272 does not apply to the tax."
[110] *See* Comptroller Rules 3.546 (Taxable Capital: Nexus) and 3.586 (Margin: Nexus).
[111] Comptroller's Revised Franchise Tax FAQs, available online at http://cpa.state.tx.us/taxinfo/franchise/faq.html.

- staging shows, theatrical performances, or other events within Texas;

Transportation:

- carrying passengers or freight (any personal property including oil and gas transmitted by pipeline) from one point in Texas to another point within the state, if pickup and delivery, regardless of origination or ultimate destination, occurs within Texas; or
- having facilities and/or employees, independent contractors, agents, or other representatives in Texas, regardless of whether they reside in Texas:
    - for storage, delivery, or shipment of goods;
    - for servicing, maintaining, or repair of vehicles, trailers, containers, and other equipment;
    - for coordinating and directing the transportation of passengers or freight; or
    - for doing any other business of the taxable entity;

Franchising:

- entering into one or more contracts with persons, corporations, or other business entities located in Texas, by which the franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system prescribed in substantial part by the franchisor; and
- the operation of a franchisee's business pursuant to such plan is substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate;

Manufacturing & Processing:

- assembling, processing, manufacturing, or storing goods in Texas;

Advertising:

- entering Texas to purchase, place, or display advertising when the advertising is for the benefit of another and in the ordinary course of business (e.g., the foreign corporation makes signs and brings them into Texas, sets them up, and maintains them);

Processing & Shipment Contracting:

- sending materials to a Texas manufacturer, processor, repairer, or printer to be processed and stored in completed form awaiting orders for their shipment;

Loan Production:

- soliciting sales contracts or loans, gathering financial data, making credit checks, or performing other financial activities in Texas through employees, independent contractors, or agents, regardless of whether they reside in Texas;

Holding Companies:

- maintaining a place of business in Texas or managing, directing, and/or performing services in Texas for subsidiaries or investee entities;

Consigning Goods:

- having consigned goods in Texas;

Delivering Goods:

- delivering into Texas items a business has sold; and

Leasing:

- leasing tangible personal property which is used in Texas.

2. Trade Show Exemption[112]

The Texas Tax Code offers a limited *de minimis* solicitation exemption for businesses limiting their Texas activities to soliciting orders of tangible personal property at trade shows.[113] The orders must be sent outside the state for approval or rejection and

[112] Texas Tax Code § 171.084.
[113] *Id.*

Back to Table of Contents

must be filled from a point outside Texas. The trade shows must be those promoted by wholesale centers, nonprofit trade associations or held at municipal or county meeting facilities. The trade shows must last less than 120 hours and must occur five times or less during the period for which nexus is measured.[114] Comptroller Rule 3.583(j) (Margin: Exemptions) also explains the exemption/nexus rules for trade show activities in the state.

3. Registering to do business in Texas is not enough to create nexus

In *Rylander v. Bandag Licensing Corporation*,[115] the Texas Supreme Court held that having a certificate of authority to do business in the state alone does not establish nexus in Texas. The taxpayer sought recovery of franchise taxes paid under protest.[116] During the audit period, Bandag Licensing Corporation (BLC) owned three patents that it licensed to Bandag, its parent corporation, under an agreement that had been executed outside Texas.[117] Under the agreement, Bandag sent royalty payments to BLC's out-of-state office. No payments were received in Texas.[118] The patents and licenses were intangible property rights.[119] Since they were not real property or tangible personal, they did not constitute nexus in Texas under the *Quill* standard.[120] Also, during BLC's audit period, the Comptroller's policy provided that the licensing of such intangibles did not create a "franchise tax nexus" with Texas. The assessment was based solely on taxpayer's possession of license to do business in state. The court determined the assessment therefore violated both the commerce and due process clauses of the United States Constitution.[121]

Bandag also argued that the existing Tax Code provision prohibiting the award of attorneys' fees in declaratory judgment actions relating to the applicability, assessment, collection or constitutionality of a tax or fee under the Tax Code was an unconstitutional barrier to access to the courts under the "open courts" provision of the Texas Constitution.[122] The Third Court of Appeals granted recovery of attorneys' fees under the UDJA, declared unconstitutional the prohibition of attorneys' fees and determined that where it is necessary for the court to determine the constitutionality of provisions of the Tax Code and the Comptroller's actions under the Tax Code, a taxpayer may appropriately seek relief of attorneys' fees under the UDJA.[123]

4. Holding intangibles under the revised franchise tax

The revised Texas franchise tax statute considers an entity to be conducting an active trade or business in Texas if assets the entity holds intangibles, including royalties, patents, trademarks, and other intangible assets, are used in the active trade or business of one or more related entities.[124] Some practitioners refer to this provision as an "anti-*Geoffrey*" statute.

Geoffrey, Inc., a subsidiary of "Toys R Us", Inc., owned the "Toys R Us" trademarks and collected licensing fees for their use by the various stores.[125] Geoffrey had no physical presence in South Carolina. Nevertheless, the South Carolina Supreme Court held that payment of royalties from the retailers to the trademark holder was sufficiently a part of the unitary business of the company to subject it to South Carolina income taxes.[126]

VI. How do you shake off nexus once you have it (or it has you)?

[114] *Id*.
[115] 18 S.W.3d 296 (Tex. App.-Austin 2000, pet. denied).
[116] *Id.*
[117] *Id.*
[118] *Id.*
[119] *Id.*
[120] *Id.*
[121] *Id.*
[122] *Id*. at 302 – 304.
[123] *Id* at 304 – 305.
[124] Texas Tax Code § 171.0004(d).
[125] *Geoffrey, Inc. v. South Carolina Dept. of Revenue and Taxation,* 510 U.S. 992 (1993).
[126] *Id.*

Tax practitioners may encounter clients in need of help with nexus questions after they have already established nexus within a particular taxing jurisdiction. There appear to be no universal standards addressing the extent or duration of nexus. Therefore, it's difficult for taxpayers to determine how long they must continue collecting and remitting tax on sales of taxable goods and services once physical presence no longer exists or keep paying a business activity tax because nexus was established. State rules vary widely. While Texas law generally considers nexus to apply for a twelve (12) month period,[127] other states, such as Washington, have historically required taxpayers to continue collecting and remitting tax for as long as five (5) years.[128]

Comptroller Rule 3.286(b)(2) requires sellers to collect and remit sales and use tax to the Texas Comptroller's office for 12 months once nexus exists.

Practice Pointer: The 12-month nexus rule also applies to local tax collection responsibilities, so if a taxpayer no longer has substantial nexus in a Texas local tax jurisdiction, but continues to make sales of taxable items in the state, the taxpayer has to continue collecting and remitting local use tax on sales of items into the jurisdiction for 12 months after the physical presence ends.

VII. Who has the burden of proof in nexus cases?

If a taxing jurisdiction claims that a person has nexus such that it seeks to impose a business activity tax liability on a person for unpaid taxes or a use tax collection responsibility and corresponding unpaid taxes that should have been collected, the taxing jurisdiction has the burden of proof. However, if in response to an assessment a constitutional challenge is raised on the basis of, for example, the commerce clause, the burden is generally on the party raising that challenge to prove the constitutional violation.[129]

VIII. State Efforts to Address Nexus – Amazon Laws

Whether due to continued state budget crises, the advent of new business models, especially those that affect sales and use tax collections in the states that impose such taxes,[130] or a combination of both, State legislatures and taxing authorities have become increasingly active in addressing nexus issues with respect to what are commonly referred to as "Amazon" laws.

"Amazon" laws concern businesses such as Amazon.com (Amazon), which has structured its business activities to have a limited physical presence in many states while having a substantial economic presence in many states. However, as we have started to see beginning in 2011, Amazon has been able to secure the ability through legislative action in Tennessee[131] and South Carolina[132] to have a physical presence in those states through ownership of

[127] *See* Comptroller Letter No. 7905L0195B02 (May 16, 1979). (noting that, at the time, California imposed a 12-month period of "lingering" nexus).

[128] *See* the Department of Revenue for Washington State Web Site under Home/Doing Business/Business Types/Out of State Businesses/Closing My Account at: http://dor.wa.gov/content/doingbusiness/businesstypes/doingbus_outofstbus.aspx#Resources. *C.f.* Special Notice, Washington Department of Revenue, September 10, 2010 (acknowledging legislation effective June 1, 2010, which changes the nexus period for Washington business and occupation (B&O) tax to the remainder of the calendar year plus one additional year. The trailing nexus standard for Washington sales and use tax is still four years plus the current year.

[129] *See Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 175 (1983).

[130] *See* "Figuring the Gap in Rival Sales Tax Studies" by Paul Demery, www.internetretailer.com, August 2, 2010 (noting that estimates of lost sales and use tax revenues due to online sales vary from $12.7 billion to $4.7 billion for 2012).

[131] *See* "Tennessee Governor Announces Amazon Agreement," 62 State Tax Notes 72 (October 10, 2011); *compare* Tennessee A.G. Opinion 11-52 (June 28, 2011) (determining that Amazon's distribution centers in that state would establish nexus without statutory action providing to the contrary); *and see* "Tennessee Lawmakers Approve Collection Break for Amazon," 63 State Tax Notes 924 (Mar. 19, 2012).

[132] *See e.g.,* "South Carolina Lawmakers Approve Exemption for Amazon," 60 State Tax Notes 693 (June 6, 2011).

warehouses, but not have to collect use taxes for a certain amount of time in exchange for creating jobs in the state. In January 2012, Indiana reached an agreement with Amazon to have it start collecting tax on January 1, 2014, unless federal legislation is passed granting remote seller authority to the states.[133] Virginia and New Jersey have also reached deals with Amazon in 2012.

In Texas, Amazon made an offer during the 2011 Legislative Session of bringing thousands of jobs and millions of dollars of investment into the state in exchange for not having to collect taxes on sales of items made into the state,[134] but its offer was not accepted and Amazon decided to close a warehouse that had been operated by a subsidiary in Irving.[135] As explained in Section V.(A.) of this paper, the Legislature ultimately passed an amendment to Tax Code § 151.107, which determines when a person is engaged in business in the state and must collect the state's use tax. The new law addresses activities like those that were engaged in by Amazon that operate warehouses and other facilities in the state through subsidiaries and other related entities.[136] On April 27, 2012, Comptroller Susan Combs and Amazon announced that Amazon would start collecting sales and tax in Texas on July 1, 2012, along with making capital investments in the form of warehouses in the state and adding Texas jobs.[137]

One thing that has caught the attention of legislatures and departments of revenue throughout the country as a reason to impose Amazon laws is the commission programs run by Internet sellers. For example, Amazon has an "Associates" program that allows persons with an in-state Web site to receive commissions whenever visitors to that Web site "click through" to the Amazon.com Web site and purchase items. The in-state Web sites might be operated by non-profits, like marching bands trying to raise money to perform in the Macy's parade, as well as for-profit sellers of goods and services. Other retailers, such as Overstock.com, have similar programs. States have determined that these programs in which in-state residents receive commissions in exchange for driving sales to various Internet sellers are activities that fit squarely within the analysis from the *Scripto* decision, discussed in section IV(D) of this paper. In fact, it was a high school hockey team's fundraising flier that caused the New York State department of revenue to start investigating Amazon's associates commission business model.[138]

Below we first discuss the Amazon law from New York because it was the first to be passed in 2008. We then identify in alphabetical order states that have passed their own versions of these laws, which fall into one of two categories – "click-through" nexus laws like those passed by New York, or reporting laws, like those first passed by Colorado. The reporting laws generally require out-of-state businesses to either voluntarily collect and remit tax from customers or notify their customers of use tax requirements and report to the state taxing authority lists of the customers and the value of products they purchased.

Some states, such as Mississippi and Nevada, have tried to pass such laws and failed to gain sufficient support to do so.[139]

In addition, the Multistate Tax Commission also started work on an "Associate Nexus Model Statute,"

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[133] *See* "Indiana Governor: Amazon Will Collect Sales Tax," 63 State Tax Notes 191 (Jan. 16, 2012).

[134] *See, e.g.,* "Amazon Negotiating for Sales-Tax Exemption in Trade for 5,000 New Texas Jobs" by Barry Harrell, *Austin American-Statesman*, June 20, 2011.

[135] *See, e.g.,* "Amazon Officially Closes Irving Center," by Maria Halkias and Terry Maxon, *Dallas Morning News*, August 4, 2011.

[136] *See* "The Empire Strikes Back: Amazon Fights Against Online Tax Efforts" by Billy Hamilton, 60 State Tax Notes 959 (June 27, 2011).

[137] See April 27, 2012 Comptroller Press Release: "Texas, Amazon Announce Agreement to Create Jobs" at www.window.state.tx.us.

[138] *See* "New York Tax Official: Team Flier Resulted in 'Amazon' Law," 62 State Tax Notes 139 (Oct.17, 2011).

[139] *See, e.g.,* "Tax Panel Declines to Pursue 'Amazon' Law," 60 State Tax Notes 630 (May 30, 2011) (explaining that the Nevada Assembly Taxation Committee declined to adopt language to a New York-style Amazon law).

Back to Table of Contents

which is patterned after New York's "Amazon" law.[140]

Practice Pointer: A taxpayer seeking to avoid nexus in a particular state, or seeking to determine if the taxpayer has any tax obligation to collect and remit tax in a particular state, may be tempted to request a written ruling from that state's department of revenue. However, some states, like Illinois, have refused to draw a bright line test to establish nexus, stating that such questions are not appropriate subject matter for taxability rulings.[141]

A. New York

In 2008, New York modified its definition of "vendor" for purposes of determining who must collect and remit sales and use taxes to include a "Commission-Agreement Provision."[142] The law "requires collection of New York taxes from New Yorkers by out-of-state sellers that contractually agree to pay commissions to New York residents for referring potential customers to them, provided that more than $10,000 was generated from such New York referrals during the preceding four quarterly periods."[143]

The law establishes a rebuttable presumption that no collection responsibility applies if the out-of-state seller has certification statements that the in-state "associates" are not engaging in solicitation activities on behalf of the out-of-state seller.[144]

Amazon challenged the New York law on a number of grounds and lost on all of them at the trial court level. With respect to the commerce clause analysis, the Supreme Court[145] found that "Amazon should not be permitted to escape tax collection indirectly, through use of an incentivized New York sales force to generate revenue, when it would not be able to achieve tax avoidance directly through use of New York employees engaged in the very same activities."[146]

At the court of appeals, the state prevailed against Amazon's claim that the law was unconstitutional on its face in violation of the due process and commerce clauses, but the court ruled that Amazon's claims that the law was unconstitutional as applied had not been adequately addressed,[147] so the parties were sent back at the trial court to determine if Amazon can prove that part of its case.

It has been reported that Amazon dropped its "as applied" challenge without prejudice, but has proceeded with it facial challenges and the dispute is now pending before the New York Court of Appeals, which is the highest court in the state.[148]

B. Arkansas

Arkansas enacted a "click-through nexus" law in 2011,[149] which presumes out-of-state sellers to be engaged in business in Arkansas if affiliated persons are subject to Arkansas jurisdiction and one of the following is true:

- The seller sells a similar line of products as the affiliate and sells them under a similar business name;
- The affiliate uses in-state employees or facilities to advertise, promote or facilitate sales;

[140] Information is available at www.mtc.gov.
[141] *See* General Information Letter IT 10-0014-GIL, Illinois Department of Revenue, June 25, 2010.
[142] *See* N. Y. Tax Law § 1101[b][8][vi] (McKinney Supp. 2010).
[143] *Amazon.com LLC v. New York State Dep't of Taxation and Finance*, 877 N.Y.S.2d 842, 846 (N.Y. Sup.Ct. 2009).
[144] *Id*.
[145] In New York State, the Supreme Court is the trial court level, similar to a Texas District Court; the Court of Appeals is the equivalent to the Texas Supreme Court.
[146] *Amazon.com* at 850.
[147] *See Amazon.com LLC v. New York Dept. of Taxation and Finance*, 81 A.D.3d 183 (N.Y. App. Div. 1st Dept., Nov. 4, 2010).
[148] *See* "Tax Academics Diverge on Colorado's 'Amazon' Law", 65 State Tax Notes 78 (July 9, 2012).
[149] *See* S.B. 738 (Ark. 2011); Ark. Code Ann. § 26-52-117.

Back to Table of Contents

- The affiliate maintains an office, distribution facility, warehouse, storage place, etc. to facilitate delivery of property or services;
- The affiliate uses trademarks, service marks, or trade names that are substantially similar to the seller's; or
- The affiliate delivers, installs, assembles or performs maintenance services for the seller's customers.

The Arkansas provisions define affiliates as controlled group members or those with similar relationships.

Even if there is no affiliate in the state, a nexus presumption applies if sales to Arkansas customers exceed $10,000 during the preceding 12-month period and the seller enters into a commission or other agreement with Arkansas residents to refer customers through a website link or other method. The presumption is rebuttable with certain proof.

C. California

In June 2011, California passed legislation taxing out-of-state companies that have either an "affiliate" or a "subsidiary" in the state.[150] Under the revised law, California defines a "retailer engaged in business in this state" to include:

- Any retailer that is a member of a commonly-controlled group and is a member of a combined reporting group that includes another member of the retailer's commonly controlled group that, pursuant to an agreement with or in cooperation with the retailer, performs services in this state in connection with tangible personal property to be sold by the retailer, including, but not limited to, design and development of tangible personal property sold by the retailer, or the solicitation of sales of tangible personal property on behalf of the retailer.[151]

- Any retailer entering into an agreement under which a person in this state, for a commission or other consideration, refers potential purchasers of tangible personal property to the retailer, whether by an Internet-based link or an Internet website, or otherwise provided that both of the following conditions are met:

  (1) The retailer's total sales of tangible personal property to California consumers that are referred pursuant to all of those agreements with a person(s) in California in the preceding 12 months must be in excess of $10,000.

  (2) The retailer's total sales of tangible personal property to California consumers in the preceding 12 months must be in excess of $500,000.

Under the new law, large out-of-state retailers that pay in-state affiliates commissions for sales completed after clicking through a link on the affiliate's website must collect California use tax.

As a result, Amazon terminated contracts with all California residents participating in the Amazon Associates Program effective June 29, 2011. In addition, Amazon decided that it would try to repeal the new law by seeking a referendum of California voters.[152] However, before any vote was cast, Amazon negotiated a deal with state legislators, AB 155, which was signed into law by the Governor. The deal provides that California will delay implementation of its click-through nexus law until September 15, 2012, in exchange for Amazon dropping its repeal efforts and seeking a federal solution by July 31, 2012.[153] In the final twist to this saga, Amazon has now invited its former affiliates located in California to rejoin its

[150] ABx1 28, 2011-2012 Leg., 1st Ex. Sess., section 1, (Cal. 2011) was signed into law by Governor Edmund G. Brown Jr. on June 29, 2011. It is codified at Calif. Revenue and Taxation Code § 6203.

[151] http://www.boe.ca.gov/news/pdf/l284.pdf.

[152] *See* "Amazon Wants Repeal of California's Click-Through Law," 61 State Tax Notes 151 (July 18, 2011).

[153] *See* "Lawmakers Approve Amazon Sales Tax Deal," 61 State Tax Notes 760 (September 19, 2011).

associate program "to earn advertising fees on qualifying sales referred to the company."[154]

D. Colorado

The Colorado "Amazon" bill was signed into law February 24, 2010.[155] The Colorado version of the law does not impose a collection responsibility on remote sellers, but gives them an option to either submit to the state information about purchases of items by persons in Colorado and send notices to their customers that use tax is due or to voluntarily collect and remit any use tax that may be due.

In response to the Colorado law, Amazon discontinued its affiliates program in the state.[156] On June 30, 2010, the Direct Marketing Association (DMA) filed a lawsuit challenging the law on the grounds that it violates both the United States and Colorado Constitutions by:

- Imposing discriminatory treatment on out-of-state retailers lacking any physical presence in the state (i.e., the statute violates the Commerce Clause);
- Trampling the right to privacy of Colorado residents, as well as certain non-residents;
- Chilling the exercise of free speech by certain purchasers and vendors of products that have expressive content;
- Exposing confidential information regarding consumers and their purchases to the risk of data security breaches; and
- Depriving retailers, without due process or fair compensation, of both the value of their proprietary customer lists and the substantial investment made to protect such lists from disclosure.[157]

On March 30, 2012, a federal district judge concluded that the Colorado law violated the Commerce Clause because it imposes an undue burden on commerce, finding that the analysis in *Quill* was equally controlling to a requirement to collect and remit tax as it was to this law's requirement to provide a report on sales into a state, and issued a permanent injunction against the state.[158] The Colorado department of revenue has appealed to the Tenth Circuit Court of Appeals.[159] Note also that due to a change in the head of the department of revenue in Colorado, the case is now styled *Direct Marketing Ass'n v. Brohl*.[160]

E. Connecticut

The Connecticut legislature passed an "Amazon" nexus presumption law to be effective as of June 21, 2011, and applying retroactively to sales made on or after May 4, 2011, which is similar to the New York "click-through" nexus law.[161] The law requires companies to meet two criteria to have nexus in Connecticut. The state defines "retailers" to include persons who sell goods or services and enter into agreements with resident independent contractors (or other representatives) who are paid commissions or other consideration for referring potential customers to the retailers. Such referrals include those done by link on an Internet website, or otherwise. The provision applies if a retailer's cumulative gross receipts from customers referred by its in-state affiliates exceed $2,000 during the preceding four quarters. The law presumes the out-of-state businesses are acting through in-state "agents." Certain foreign corporations are exempt from the economic nexus rules.[162]

F. District of Columbia

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[154] "Amazon Invites California Affiliates to Return," 62 State Tax Notes 67 (Oct. 10, 2011).
[155] *See* § 39-21-112(3.5), C.R.S. (2010).
[156] *See, e.g.,* Miles Moffeit and Jessica Fender, *Amazon.com drops Colorado retailers after tax law enacted*, *The Denver Post*, March 9, 2010.
[157] *Direct Marketing Association v. Huber*, No. 10-cv-01546-REB-CBS, In the United States District Court for the District of Colorado, p. 2 of the Complaint, June 30, 2010.
[158] *See Direct Mktg. Ass;n v. Huber,* 2012 U.S. Dist. LEXIS 44468 (D. Colo., March 20, 2012)
[159] *See* "Tax Academics Diverge on Colorado's 'Amazon' Law," 65 State Tax Notes 78, July 9, 2012.
[160] *Id.*
[161] *See* H.B. 6652, §§ 46, 47 (Conn. 2011).
[162] *See* Conn. Gen. Stat. § 12-407(a)(12)(L).

The District of Columbia has enacted the "Fiscal Year 2012 Budget Support Act of 2011," which includes "remote-vendor" sales and use tax collections.[163] A "remote-vendor" is a seller, with or without nexus in D.C., which sells property or renders services via Internet over a dollar amount (to be specified) to a purchaser located in D.C. The "remote-vendor" provisions are effective upon enactment by Congress.

Effective October 1, 2011, a "nexus-vendor's sales of tangible personal property or services are taxable in the District. The statute excepts tangible personal property that is not located in D.C. when the contract is executed or is not sold by a "nexus-vendor." A "nexus-vendor" is one that has a physical presence in the District and renders services or sells property to D.C. residents via the Internet.

G. Georgia

Georgia's HB 386, Sections 6-1 and 7-1, as signed into law in 2012 includes a "click-through" nexus provision that is effective October 1, 2012. It provides that a person is a "dealer" who has to collect sales and use tax under Georgia Code Section 48-8-2, paragraph (8)(M), if a person:

(i) Enters into an agreement with one or more other persons who are residents of this state under which the resident, for a commission or other consideration, based on completed sales, directly or indirectly refers potential customers, whether by a link on an Internet website, an in-person oral presentation, telemarketing, or otherwise, to the person, if the cumulative gross receipts from sales by the person to customers in this state who are referred to the person by all residents with this type of an agreement with the person is in excess of $ 50,000.00 during the preceding 12 months.

(ii) The presumption that a person described in this subparagraph is a dealer in this state may be rebutted by submitting proof that the residents with whom the person has an agreement did not engage in any activity within this state that was significantly associated with the person's ability to establish or maintain the person's market in the state during the preceding 12 months. Such proof may consist of sworn written statements from all of the residents with whom the person has an agreement stating that they did not engage in any solicitation in this state on behalf of the person during the preceding year, provided that such statements were provided and obtained in good faith. This subparagraph shall take effect 90 days after the effective date of this Act and shall apply to sales made, uses occurring, and services rendered on or after the effective date of this subparagraph without regard to the date the person and the resident entered into the agreement described in this subparagraph.

H. Illinois

On March 10, 2011, the Illinois governor signed his state's Amazon law. Like the New York Amazon law, the Illinois law creates nexus for an entity that pays commission to someone in the state for referral through a link if $10,000 in commissions is paid in a 12 month period.[164]

The newly enacted statute also extends nexus to a taxpayer that pays commission to an instate retailer with a similar name selling a substantially similar line of products. [165]

In response, the Performance Marketing Association (PMA), which represents the interests of those who provide advertising on the Internet via a model where advertising costs are based on sales results (i.e., "performance"), filed suit against the state on June 1, 2011 claiming that the law violates the Commerce Clause and the Internet Tax Freedom Act.[166]

[163] 2011 D.C. Bill 19-0338, D.C. Act 19-0093.

[164] See Public Act 096-1544 (Ill. 2011); 35 ILCS 105/2 and 110/2.

[165] *Id.*

[166] *See* Case No. 1:11-cv-03690, N.D. Ill (June 2, 2011).

Back to Table of Contents

After considering cross motions for summary judgment and arguments of the parties, an Illinois circuit court judge (which is the equivalent of a Texas district court judge) found the law unconstitutional under the commerce clause and also found that it violated the Internet Tax Freedom Act's prohibition against discriminatory taxes on e-commerce. Only a simple order without analysis was issued on May 17, 2012.[167] The Illinois Department of Revenue has appealed directly to the state's supreme court.[168]

I. North Carolina

North Carolina passed its own version of an Amazon law patterned after New York's "click-through" nexus statute, which became effective August 7, 2009.[169]

J. Oklahoma

Oklahoma's version of an Amazon bill, which is one of the reporting statutes, became law on May 2010.[170] It requires the following:

> Each retailer or vendor making sales of tangible personal property from a place of business outside this state for use in this state that is not required to collect use tax, shall provide notification on its retail Internet website or retail catalog and invoices provided to its customers that use tax is imposed and must be paid by the purchaser, unless otherwise exempt, on the storage, use, or other consumption of the tangible personal property in this state. The notification shall be readily visible. It is further provided that no retailer shall advertise on its retail Internet website or retail catalog that there is no tax due on purchases made from the retailer for use in this state.

The Oklahoma Tax Commission has promulgated a rule to provide further guidance.[171]

Recent changes to Oklahoma law also allowed Oklahoma to expand nexus to online retailers with a brick and mortar location in the state. The statute taxes companies either owned or who owned an entity with nexus in the state that was in a substantially similar line of business.[172] In addition, companies could have nexus when a related entity used its' affiliates resources in delivering property sold in the state.

By expanding nexus to related companies using in state retailers to carry out their business, Oklahoma is also looking to make online retailers associated with brick and mortar stores within Oklahoma subject to nexus. Large nationwide retailers sometimes create a separate company for their online sales that would not have nexus in a state on its own accord. The unitary business premise has been used by some states in these scenarios to attribute affiliate nexus to the online retailer because of their use of the brick and mortar counterpart within the state.[173]

The statute takes affiliate nexus one step further by presuming that a member of a controlled group with a related retailer doing business in the state is doing business in state. However, an entity in a controlled group can rebut this presumption by showing they did not aid the retailer doing business in the state.

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167 *See Performance Mktg Ass'n, Inc. v. Hamer*, In the Circuit Court of Cook County, Illinois, County Department – Law Division, Tax and Miscellaneous Remedies Section, No. 2011 CH 26333, May 7, 2012.

168 See "Illinois DOR to Appeal 'Amazon' Case to State Supreme Court," 64 State Tax Notes 514 (May 21, 2012).

169 *See* N.C. Gen Stat. § 105-164.8(b)(3).

170 *See* 2009 Okla. HB 2359, 52nd Leg., 2nd Sess. (Okla. 2010). .

171 *See* Stat. § 710:65-21-8.

172 OKLA. STAT. tit. 68, § 1401 (2010)

173 *Compare Borders Online, LLC v. State Bd. of Equalization*, 29 Cal. Rptr. 3d 176 (Cal. Ct. App. 2005) (holding that Borders Online had nexus in California because of its affiliate had brick and mortar Borders stores in the state), *with St. Tammany Parish Tax Collector v. Barnesandnoble.com*, LLC, 481 F. Supp. 2d 575 (E.D. La. 2007) (holding that despite a customer being able to return items to the brick and mortar locations in the state there was no nexus).

Back to Table of Contents

K. Pennsylvania

Although no new law has been passed, be aware that the Pennsylvania Department of Revenue has issued Sales and Use Tax Bulletin 2011-01 (December 1, 2011), which informs remote sellers that they are considered to maintain a place of business in the state and must collect sales taxes if the seller "regularly solicits orders from Pennsylvania customers via the website of an entity or individual physically located in Pennsylvania, such as via click-through technology." The Department has delayed implementation from February 1, 2012 to September 1, 2012.[174]

L. Rhode Island

The Rhode Island Amazon law became effective July 1, 2009. The Rhode Island law sets out similar requirements to New York's Amazon law; however, gross receipts generated by such referrals only need to aggregate $5,000 during the preceding four quarterly periods.[175] Despite its recent enactment, a bill was introduced attempting to repeal Rhode Island's Amazon law in January, 2010.[176]

M. South Dakota

This state's law passed in 2011 which, similar to Colorado and Oklahoma, provides that "noncollecting retailers" who operate an online auction or are selling taxable items into the state must provide notice on their Web sites and invoices to South Dakota purchasers that they have a use tax obligation, while also providing for de minimis thresholds for small sellers.[177]

N. Utah

Effective July 1, 2012, Utah's affiliate nexus law will require sellers to pay or collect and remit taxes if they are engaged in the business of selling tangible personal property, a service, or a product transferred electronically for use in the state. The tax applies to:

(i) a seller holding a substantial ownership interest in, or that is owned in whole or substantial part by a related seller; and

(ii) the seller sells the same or a substantially similar line of products under the same name or a substantially similar name; or

(iii) the related seller's place of business or an in-state employee is used to advertise, promote or facilitate sales by the seller to the purchaser.[178]

O. Vermont

In 2011, the Vermont legislature enacted a "click-through" nexus provision, which requires remote sellers who do not collect Vermont tax from their customers to notify purchasers that Vermont use tax is due on nonexempt purchases. The provision applies to taxpayers with gross receipts from sales exceeding $10,000 during the preceding tax year.[179] Note, however, that the law includes a requirement that remote sellers actually collect Vermont use taxes when the state's Attorney General determines that 15 other states have adopted similar laws.[180]

IX. Issue to Watch: Cloud Computing

A current hot topic in the sales and use tax area with respect to nexus concerns sales of what are commonly referred to as "cloud computing services."

[174] *See* "Pennsylvania DOR to Delay Affiliate Nexus Collection," 63 State Tax Notes 444, January 27, 2012.
[175] R.I. GEN. LAWS § 44-18-15 (2010).
[176] *See* H 7071, (R.I. 2010)
[177] *See* 2011 S.D. SB 146, 86th Leg. Assem.. (S.D. 2011)
[178] H.B. 384, Laws (Utah 2012).
[179] See H 436 (Vermont 2011); Vt. Stat. Ann. tit.32, § 9701(9)(l).
[180] *See, e.g.,* "Vermont Governor Approves Modified 'Amazon' Law," 60 State Tax Notes 694 (June 6, 2011).

While providers may refer to the products they sell as "Software as a Service (SaaS)," "Platform as a Service (PaaS)," or "Infrastructure as a Service (IaaS)," sellers and purchasers of these services must be mindful if and how these items are taxed and how nexus rules apply.

In a recent article, the COO of Netsuite, a provider of cloud computing services, indicated that "when his company plans an acquisition, it may have to spend up to $1.5 million simply to clean up sales-tax disputes."[181] Thus, astute tax practitioners should be spending time educating themselves and their colleagues who work with companies that provide these services and those who work on M&A deals to be mindful that there are expensive minefields that exist if everyone does not understand what is taxable and where, and what nexus rules might apply to determine who is responsible for remitting any taxes that are due – the seller because it has substantial nexus or the purchaser because the seller does not have nexus.

This issue ties into the broader discussion taking place in many departments of revenue concerning how digital goods and services should be taxed and what taxing jurisdictions are entitled to any tax that is due. Texas considers many of these items taxable as either the sale of software[182] or the sale of data processing services[183] under statutes that have been on the books for many years. Yet, when these items exist "in the cloud," knowing when and where such items are sold or used is a challenge. As discussed in Section V.(A) of this paper, the Texas legislature has made changes this year to the definition of nexus for some purchasers of these types of services, but, arguably, more work is needed so that both taxpayers and the Comptroller's office have additional guidance about the taxability of these items based on nexus considerations.

On June 28. 2012, the House Judiciary Committee voted out for consideration by the U.S. House of Representatives H.R. 1860, the Digital Goods and Services Tax Fairness Act.[184] The bill would establish definitions and sourcing rules for sales of digital goods and services and prohibit multiple and discriminatory taxes on such items and those who sell them. The Comptroller has estimated the revenue loss to Texas at $100 million per year if this bill becomes law.

X. Federal Legislation to Watch on Nexus Issues – Changing the rules for the Nexus Hokey Pokey

The United States Congress has shown an interest in bills and issues that affect state and local nexus and held hearings on the topic.[185] The following bills have been filed in the current Congress, which could dramatically changes how states and taxpayers deal with nexus issues. Even if these bills do not become law during this session of Congress that will end on January 3, 2013, we expect them to be filed in future sessions of Congress.

A. Business Activity Taxes

The Committee Report has now been filed on the Business Activity Tax Simplification Act of 2011, H.R. 1439, (BATSA) meaning that the full House can consider the bill at any time. BATSA would prohibit states from following an economic nexus standard, and instead would amend P.L. 86-272 in several respects, including establishing a physical presence standard; broadening the scope of the law to apply to all types of business activity taxes, not just income

[181] "Taxing the Cloud" by David Rosenbaum at www.CFO.com, October 25, 2011.

[182] *See* Texas Tax Code §§ 151.0031(Computer Program), 151.009 (Tangible Personal Property), and 151.010 (Taxable Item).

[183] *See* Texas Tax Code §§ 151.0035 (Data Processing Services), 151.0101(a)(12) (Taxable Services), and 151.351 (Information Services and Data Processing Services).

[184] *See* "U.S. House Judiciary Committee Passes Digital Goods Bill," 65 State Tax Notes 7, July 2, 2012.

[185] The "State Taxation: The Role of Congress in Defining Nexus" hearing was held February 4, 2010. A transcript of the proceedings including copies of written testimony and post-hearing questions as submitted to those testifying and others is available at http://judiciary.house.gov/hearings/printers/111th/111-68_54763.PDF.

Back to Table of Contents

taxes; and applying the law to all types of items sold into a state, not just tangible personal property.

To date no companion bill has been filed in the Senate, and it is assumed that, just as in 2006 when an earlier version of BATSA came to the House floor for a full vote, the loss of revenue that the states would experience might cause the bill to fail. The CBO has determined that all affected states would lose $2 billion in 2012.[186] The Comptroller has determined that Texas would lose $1.175 billion dollars between 2012 and 2016 if BATSA became law.

B. Sales & Use Taxes

For several years now, states that have joined the Streamlined Sales & Use Tax Agreement[187] have been working on federal legislation that would allow those states to impose collection authority on remote sellers in exchange for the simplifications to collection requirements and definitions of taxable items that those states have adopted in their laws and department of revenue rules and policies. Twenty-four states are currently members, but larger states like Texas, California, New York and Illinois are not.

In 2011, federal legislation to obtain the goal of remote collection authority was filed in the House and Senate in the form of the Main Street Fairness Act,[188] but the Streamlined states have not been successful at garnering meaningful support for the bills and many people believe that they will never pass.

In response, and based on a desire to level the playing field between online sellers and brick & mortar stores that also have online shopping options that collect taxes on remote sales because of their physical presence in the states, various "big box" stores have banded together through the Retail Industry Leaders Association to draft their own bill. It is called the Marketplace Equity Act, H.R. 3179, and was filed in October 2011 in the U.S. House of Representatives.

In addition, a number of Senators have drafted a bill that is similar to the Marketplace Equity Act and they are attempting to garner support from big states like Texas and California as well as Senators from both sides of the aisle. It is the Marketplace Fairness Act, S. 1832, filed on November 9, 2011.

Both bills would provide a path for Streamlined and non-Streamlined states, like Texas, to impose collection responsibilities on remote sellers. However, both bills would require statutory and agency system changes in Texas, such that the earliest Texas could impose such responsibility would likely be 2014, even if either bill became law before then. Comptroller staff is monitoring both the Marketplace Equity Act and Marketplace Fairness Act. While the Comptroller has not announced support for any specific bill, she has stated that she supports federal legislation that would level the playing field between in-state and out-of-state sellers.

XI. Conclusion

Lawmakers at the state, local, and federal level, along with the courts, taxpayers, and tax administrators will continue to grapple for the foreseeable future to determine the legal and fair boundaries for when business activity taxes must be paid and when use taxes must be collected based on contacts with a taxing jurisdiction.

Being able to provide counsel about state and local tax responsibilities based on nexus determinations may make the difference between a small business surviving and a larger business being able to grow. States will continue to be concerned about how federal laws affect state revenues and the ability to administer their tax systems.

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[186] Available at http://www.cbo.gov/ftpdocs/124xx/doc12415/hr1439.pdf

[187] *See* www.streamlinedsalestax.org.

[188] *See* H.R. 2701 and S. 1542 (112th Congress, 1st Session).

Back to Table of Contents

DECANTING IRREVOCABLE TRUSTS

By: *Melissa J. Willms*[*]

I. INTRODUCTION.

The term "decanting" sounds mysterious and evokes fear in some estate planning attorneys. In reality, decanting can simply be thought of as a form of trust modification that is initiated by a trustee. In the strictest sense, the modification is accomplished by moving assets from one trust to a new trust with different terms. While it may sound simple on its face, decanting involves a host of issues from the perspective of state law as well as federal tax law.

Many times, estate planning attorneys draft trusts which are designed to last several generations, even though no one can know exactly what the future may hold, especially the future of the beneficiaries. Decanting comes from this standpoint: where changes are desired in an otherwise irrevocable trust.

II. WHAT IS DECANTING?

Interestingly, the term "decanting" is not defined in the Internal Revenue Code or Treasury regulations. Since the IRS issued Notice 2011-101 in December 2011 (Notice 2011-101, 2011-52 I.R.B. 932) seeking comments regarding the various tax issues associated with decanting, we may well see the IRS issue a formal definition.

In general terms, decanting is the exercise by a trustee of the trustee's discretionary authority to distribute trust property to or for the benefit of trust beneficiaries by distributing assets from one trust to another trust. Although not referred to as decanting, the concept can be found in the Restatement (Second) of Property: Donative Transfers (1986) ("Restatement Second") and the Restatement (Third) of Property: Wills and Other Donative Transfers (2011) ("Restatement Third").

In the Restatement Second, a trustee's power to distribute property is akin to a special power of appointment. RESTATEMENT (2D) OF PROP: DONATIVE TRANSFERS § 11.1, cmt. d. According to the Restatement Second, "a power of appointment is authority, other than as an incident of the beneficial ownership of property, to designate recipients of beneficial interests in property." RESTATEMENT (2D) OF PROP: DONATIVE TRANSFERS § 11.1. Because a trustee who has discretionary authority to distribute trust property to beneficiaries does not have a beneficial interest in the trust property but can determine those persons who do have a beneficial ownership, the trustee is said to have a special power of appointment over the trust property. The Restatement Second terms the trustee's power as a special power because the trustee has the power to transfer all or less than all of the title authorized by the trust agreement. RESTATEMENT (2D) OF PROP: DONATIVE TRANSFERS § 11.1. The Restatement Second further provides that unless the donor provides otherwise, when the donor gives the powerholder the right to dispose of the property, the powerholder has the same rights that the powerholder would have if he or she owned the property and was giving it to the object of the power. RESTATEMENT (2D) OF PROP: DONATIVE TRANSFERS § 19.3. It follows that if a trustee has the power and discretion to transfer *full* legal title to a beneficiary, then the trustee should be able to transfer *less than* full legal title by transferring the property *in trust* for the beneficiary since the beneficial interests are still being transferred to the beneficiary who is a proper object of the power. *Id*. The Restatement

Second does not address whether this power is held in a fiduciary or nonfiduciary capacity. Presumably, because the power is being exercised by a trustee, it is being exercised in a fiduciary capacity.

The Restatement Third makes an important clarification with regard to decanting, although interestingly, the term "decanting" is still not used. In the Restatement Third, a distinction is made between powers of appointment and fiduciary distributive powers. Specifically, a power of appointment may be exercised in a nonfiduciary capacity, may be exercised arbitrarily, is personal to the powerholder, and lapses upon the powerholder's death or other specified expiration if not exercised. RESTATEMENT (3D) OF PROP: WILLS AND OTHER DONATIVE TRANSFERS § 17.1. In contrast, a fiduciary distributive power is subject to the same general rules regarding powers of appointment, but the power must be exercised in a fiduciary capacity, it succeeds to any successor trustee, and it survives the death of a trustee. *Id*. Now, instead of decanting being simply likened to a power of appointment, decanting is likened to a power of appointment, subject to fiduciary standards. It may seem obvious that if a trustee is going to decant assets from one trust to a new trust, the trustee must act as a fiduciary. Even though obvious, it is critically important that when deciding whether to decant, the trustee examine all fiduciary duties applicable to the trust.

In addition, the Restatement Third specifies that unless the creator of a special power of appointment prohibits the exercise of the power in favor of a trust, the powerholder may exercise the power in favor of permissible appointees and appoint the property in trust. RESTATEMENT (3D) OF PROP: WILLS AND OTHER DONATIVE TRANSFERS § 19.14. Since a fiduciary distributive power is subject to the same general rules as powers of appointment, the ability to appoint in trust would also apply in a decanting situation.

Remember that although the term is new, decanting is not. The most cited case that examines the decanting of a trust is the Florida case of *Phipps v. Palm Beach Trust Co.,* 196 So. 299 (Fla. 1940). In *Phipps*, a trust created in 1932 for the benefit of the grantor's beneficiaries, gave the individual trustee the discretion to distribute some or all of the income and principal of the trust to any one or more of the grantor's descendants. The individual trustee gave written instructions to the corporate trustee to transfer all of the trust property to a new trust for the benefit of the grantor's descendants, with the difference being that the new trust gave one of the descendants a testamentary power to appoint income to that descendant's spouse. The corporate trustee filed suit seeking approval of the transaction. In reviewing the trust agreement and the limited class of persons to whom the trustee could distribute the trust property, the court determined that the individual trustee had a special power of appointment. The court cited the general rule that unless the grantor clearly states a contrary intent, when a trustee is given the power to create an estate in fee, then the trustee may create an estate in less than fee. Given the broad discretion to the individual trustee, the court approved the decanting. *See also, In re: Est. of Spencer*, 232 N.W. 2d. 491 (Iowa 1975) (authorizing a beneficiary-trustee's exercise of a special power of appointment in favor of a new trust); *Wiedenmayer v. Johnson*, 254 A.2d. 534 (N.J. Super. Ct. App. Div. 1969) (in authorizing a trustee's fiduciary power to distribute property to a beneficiary to include the power to distribute to trust for beneficiary, court reasoned trustees' discretionary power was in best interest of beneficiary and not an abuse of discretion).

III. REASONS TO DECANT.

Times change, needs change, laws change. Because of these and other reasons, a trustee may find the need to decant. Examples of reasons to decant, which may also apply in the trust modification or reformation context, include:

- correct a drafting mistake
- clarify ambiguities in the trust agreement
- correct trust provisions due to mistake of law or fact to conform to the grantor's intent
- update trust provisions to include changes in the law, including new trustee powers
- change situs of trust administration for administrative provisions or tax savings
- combine trusts for efficiency
- allow for appointment or removal of trustee without court approval
- allow appointment of special trustee for limited time or limited purpose
- change trustee powers, such as investment options
- transfer assets to a special needs trust
- adapt to changed circumstances of beneficiary, such as substance abuse, creditor or marital issues, including modifying distribution provisions to delay distribution of trust assets
- add a spendthrift provision
- divide pot trust into separate share trusts
- partition of trust for marital deduction or generation-skipping ("GST") transfer tax planning

IV. DECANTING VS. TRUST MODIFICATION

A. Fiduciary Duties of Trustees. When taking any action, including decanting or a trust modification, the trustee must consider whether the action falls within the various fiduciary duties the trustee owes to the beneficiaries. The trustee cannot act arbitrarily. Two principles underlie much of the Anglo-American law of fiduciary duties: the duties of loyalty and of prudence. Specific duties as applied to trustees vary from state to state, but a number of general principles can be described. A discussion of a few of these duties specific to Texas law follows.

1. Duty of Loyalty. Without question, the duty of loyalty is one of the most basic fiduciary duties of a trustee and underlies virtually every action of a trustee. The duty of loyalty requires that the trustee act in the best interests of the beneficiaries above the trustee's own interests and be fair and impartial to all beneficiaries. The duty of a trustee to avoid self-dealing is a subpart of the duty of loyalty.

2. Fiduciary Duty to Be Generally Prudent. The trustee has a duty to act reasonably and competently in all matters of trust administration, not just in investment matters. A trustee must administer a trust in good faith and according to the terms of the trust and the Texas Trust Code while also performing all duties under common law. TEX. PROP. CODE § 113.051. Although a prior version of a Texas statute specifically stated that a trustee must act as an ordinary prudent person, this requirement was deleted when Texas adopted the Uniform Prudent Investor Act. Presumably, the duty still applies based on common law. *See* former TEX. PROP. CODE § 113.056(a).

3. Duty to Control and Protect Trust Property. Common law imposes numerous duties on the trustee with regard to the trustee's duties to control and protect trust property, such as insuring the trust property and enforcing claims against third parties. A trustee has a duty of loyalty requiring the trustee to manage the trust assets solely in the interest of the beneficiaries. TEX. PROP. CODE § 117.007. Accordingly, the Texas Trust Code has limitations on acts of self dealing. TEX. PROP. CODE §§ 113.052 *et seq.* If a trust has two or more beneficiaries, the trustee must act impartially in investing and managing trust assets, taking into account any differing interests of the beneficiaries. TEX. PROP. CODE § 117.008. After becoming trustee or receiving trust assets, a trustee has a reasonable time to review the assets and decide what to do with them, in order to bring the trust into compliance with its purposes, terms, the Texas Trust Code, etc. TEX. PROP. CODE § 117.006. A successor trustee must make a reasonable effort to compel a predecessor trustee to deliver trust property. TEX. PROP. CODE § 114.002.

4. Duty to Inform and Report. A fundamental duty of a trustee is to keep the beneficiaries reasonably informed of the administration of the trust. *Huie v. DeShazo*, 922 S.W.2d 920 (Tex. 1996); *Montgomery v. Kennedy*, 669 S.W.2d 309 (Tex. 1984). An incident of the trustee's general duty to account and the trustee's particular duty to provide information is the trustee's duty to keep written accounts that show the nature, amount, and administration of the trust property and all acts performed by the trustee. *See* TEX. PROP. CODE § 113.151; *Corpus Christi Bank & Trust v. Roberts*, 587 S.W.2d 173 (Tex. Civ. App.–Corpus Christi 1979); *Shannon v. Frost Nat'l Bank*, 533 S.W.2d 389 (Tex. Civ. App.–San Antonio, 1975, *no writ*). Disclosure to beneficiaries need not take the form of audited financial statements, and when beneficiaries have long accepted informal financial statements and tax returns in lieu of more formal accountings, they may be estopped from insisting upon more formal disclosures. *Beaty v. Bales*, 677 S.W.2d 75 (Tex. App.–San Antonio, 1984, *writ ref'd n.r.e.*). Keep in mind that a beneficiary does have the right to demand an accounting. TEX. PROP. CODE §§ 113.151, .152. In the case of decanting, the trustee's duty to inform calls into question the need for a trustee to inform the beneficiaries prior to or concurrent with the decanting.

5. Implications of Fiduciary Duties. The purpose of the decanting is an important factor in determining the interaction with and impact on a trustee's fiduciary duties. For example, decanting to make purely administrative changes should not raise problems with a trustee's duty of loyalty. However, if a trustee's actions will cause a preference for one beneficiary over another or shift beneficial interests, duty of loyalty issues may arise. If the trust agreement includes provisions permitting decanting, this language may be enough authority for the trustee to act, but it does not mean the action is proper or falls within the trustee's fiduciary duties. More protection would be provided to the trustee by including additional language in the trust agreement which exonerates the trustee for exercising the discretionary authority to decant.

When the trust agreement is silent as to a specific type of decanting, a trustee may believe that it would be best to obtain consent by beneficiaries or a release from the beneficiaries. In the alternative, a trustee may believe that it would be best to obtain a court order approving the decanting. As discussed below, however, there are potential tax consequences to such actions. Commentators have suggested the better approach would be to use a receipt and refunding agreement or include an indemnification agreement in the new trust.

See, Aghdami & Chadwich, "Decanting Comes of Age," ABA Tax Section, Est. and Gift Tax Comm. (2011); Culp & Mellen, "Trust Decanting: An Overview and Introduction to Creative Planning Opportunities," 45 REAL PROP., TR. & EST. L. J. 3 (Spring 2010).

Absent any tax concerns or other issues, if the trustee has an overriding concern about liability, the best course may be to seek a judicial modification in order to provide the trustee with the "cover" of a court order. If the grantor wants maximum flexibility in the trust balanced with minimizing a trustee's concerns with liability, the grantor may consider giving a third party, in a nonfiduciary capacity, the power to appoint trust property to another trust.

B. Modifying and Terminating Trusts. What if our estate planning was not so far-sighted as to put all of the flexibility we want into the estate plan? Is it too late to modify or terminate the so-called "irrevocable" trusts that we have created? If they can be changed, what are the tax and other consequences of doing so? For an excellent discussion of the procedures and issues involved in terminating and modifying trusts, *see* Reis, "Irrevocable or Not? Modifications to Trusts," 33rd Annual State Bar of Texas Adv. Est. Planning & Prob. Course (2009). For another comprehensive discussion, see, Karisch, "Modifying and Terminating Irrevocable Trusts," 23rd Annual State Bar of Texas Adv. Est. Planning & Prob. Course (1999) (see updated version at www.texasprobate.net).

1. Modifications Under Common Law. The common law has long contained a well established, if very limited, notion of trust modification, known as the "doctrine of deviation." In fact, even prior to the adoption of the Texas Trust Code in 1983, the legislature recognized this rule. Section 46(c) of the Texas Trust Act provided:

> Nothing contained in this Section of this Act shall be construed as restricting the power of a court of competent jurisdiction to permit and authorize the trustee to deviate and vary from the terms of any will, agreement, or other trust instrument relating to the acquisition, investment, reinvestment, exchange, retention, sale, supervision or management of trust property.

TEX. REV. CIV. STAT. ANN., ART. 7425b-46(c) (Vernon, 1981) (repealed effective January 1, 1984).

The doctrine of deviation was summarized by the Dallas Court of Civil Appeals:

> A court of equity is possessed of authority to apply the rule or doctrine of deviation implicit in the law of trusts. Thus a court of equity will order a deviation from the terms of the trust *if it appears to the court that compliance with the terms of the trust is impossible, illegal, impractical or inexpedient, or that owing to circumstances not known to the settlor and not anticipated by him, compliance would defeat or substantially impair the accomplishment of the purpose of the trust*. [citation omitted]. In ordering a deviation a court of equity is merely exercising its general power over the administration of trust; it is an essential element of equity jurisdiction.

Amalgamated Transit Union v. Dallas Pub. Transit Bd., 430 S.W.2d. 107, 117 (Tex. Civ. App.—Dallas 1968, writ ref'd) [emphasis added]. *See also* RESTATEMENT OF LAW OF TRUSTS, (2nd ed.) §167.

Courts have frequently exercised the power to deviate from the administrative provisions of a trust instrument in order to give full effect to its dispositive or beneficial provisions. *See* RESTATEMENT OF LAW OF TRUSTS, (2nd ed.) §167. Scholars have maintained, however, that courts should proceed more carefully when deviating from the dispositive or beneficial scheme. *See* Bogert, TRUSTS AND TRUSTEES (2nd ed.) §561. This limitation doesn't preclude a court from altering the grantor's dispositive scheme. Rather it means the court must exercise more care. Examples in Bogert where the dispositive scheme may be altered are cases where a statute (such as Section 112.054 of the Texas Trust Code, discussed below) supports the court action or cases where the parties to litigation enter into a compromise agreement altering trust terms which the court finds to be fair and reasonable. *See* Bogert, TRUSTS AND TRUSTEES (2d Ed. Rev.), §994. It appears that, notwithstanding the common law authority to modify and terminate trusts, Texas courts have traditionally shown reluctance to apply these equitable principles. For example, in *Frost National Bank v. Newton*, 554 S.W.2d. 149 (Tex. 1977), the Texas Supreme Court held that a trust could not be terminated on the basis that its principal purposes had been satisfied because the court could not substitute its judgment for that of the grantor in determining which purposes she considered "principal" and which were merely "incidental." 554 S.W.2d. at 154.

2. Modifications Under the Texas Trust Code. Perhaps in response to the general unwillingness of courts to act, in 1984, the Texas legislature adopted a statutory provision adopting the doctrine of deviation as stated in Section 167 of the Restatement 2d of the Law of Trusts and in *Amalgamated Transit Union*. In 2005, legislation sponsored by the Real Estate, Probate and Trust Law Section of the State Bar of Texas broadened Section 112.054 of the Texas Trust Code. The legislation added many of the trust modification and termination provisions outlined in the Uniform Trust Code. These changes generally expand the bases for judicial modification or termination of irrevocable trusts, making it easier to meet the statutory standard.

a. *Statutory Language*. The current version of the statute provides:

Sec. 112.054. JUDICIAL MODIFICATION OR TERMINATION OF TRUSTS.

(a) On the petition of a trustee or a beneficiary, a court may order that the trustee be changed, that the terms of the trust be modified, that the trustee be directed or permitted to do acts that are not authorized or that are forbidden by the terms of the trust, that the trustee be prohibited from performing acts required by the terms of the trust, or that the trust be terminated in whole or in part, if:

(1) the purposes of the trust have been fulfilled or have become illegal or impossible to fulfill;

(2) because of circumstances not known to or anticipated by the settlor, the order will further the purposes of the trust;

(3)modification of administrative, nondispositive terms of the trust is necessary or appropriate to prevent waste or avoid impairment of the trust's administration;

(4) the order is necessary or appropriate to achieve the settlor's tax objectives and is not contrary to the settlor's intentions; or

(5) subject to Subsection (d):

(A) continuance of the trust is not necessary to achieve any material purpose of the trust; or

(B) the order is not inconsistent with a material purpose of the trust.

(b) The court shall exercise its discretion to order a modification or termination under Subsection (a) in the manner that conforms as nearly as possible to the probable intention of the settlor. The court shall consider spendthrift provisions as a factor in making its decision whether to modify or terminate, but the court is not precluded from exercising its discretion to modify or terminate solely because the trust is a spendthrift trust.

(c) The court may direct that an order described by Subsection (a)(4) has retroactive effect.

(d) The court may not take the action permitted by Subsection (a)(5) unless all beneficiaries of the trust have consented to the order or are deemed to have consented to the order. A minor, incapacitated, unborn, or unascertained beneficiary is deemed to have consented if a person representing the beneficiary's interest under Section 115.013(c) has consented or if a guardian ad litem appointed to represent the beneficiary's interest under Section 115.014 consents on the beneficiary's behalf.

b. *Application of the Statute*. While the statute appears to provide a comprehensive way to modify trusts, its application is in many ways quite limited.

(i) Trustee or Beneficiary May Bring Suit. Section 112.054(a) provides that a trustee or a beneficiary may petition the court. A "beneficiary" is a person "for whose benefit property is held in trust, regardless of the nature of the interest." TEX. PROP. CODE § 111.004(2). It therefore appears that any beneficiary—income, remainder, contingent remainder—has standing to bring a modification or termination suit. Note that the statute does not authorize a grantor to bring a suit. A grantor may be an "interested person" for purposes of Section 115.011 (the "parties" section), but the statute doesn't empower actions by interested parties. It seems unlikely that a grantor would survive a standing challenge if the grantor sought to initiate a Section 112.054 action.

(ii) Authority of Court. Section 112.054 is entitled "Judicial Modification or Termination of Trusts." It nevertheless authorizes the court to do more than modify administrative terms or terminate a trust. In particular, the statute authorizes the court to: (i) change the trustee; (ii) modify the terms of the trust; (iii) direct or permit the trustee to do acts that are not authorized or that are forbidden by the terms of the trust; (iv) prohibit the trustee from performing acts required by the terms of the trust; or (v) terminate the trust in whole or in part. While this list is fairly broad, it certainly does not authorize a court to ignore a trust in its entirety or re-write the trust from scratch. It is likely that decanting under common law provides much broader authority to change trust terms. Statutory decanting certainly does.

(iii) Findings Required. Prior to the 2005 changes, the court could act under Section 112.054 only if it found that (1) the purposes of the trust have been fulfilled or have become illegal or impossible to fulfill; or (2) because of circumstances not known to or anticipated by the grantor, compliance with the terms of the trust would defeat or substantially impair the accomplishment of the purposes of the trust. The new statute keeps the first ground, but substantially reduces the burden for establishing the second ground (from "defeat or substantially impair" to "further the purpose of the trust"). In addition, the new statute adds three new grounds for modifying or terminating a trust, allowing changes: (i) to nondispositive terms of the trust if necessary or appropriate to prevent waste or avoid impairment of the trust's administration; (ii) to achieve the grantor's tax objectives if not contrary to the grantor's intentions; or (iii) to terminate a trust that is not necessary to achieve any material purpose of the trust, or if termination is not inconsistent with a material purpose of the trust.

(iv) Spendthrift Clauses Not an Impediment. Texas Trust Code Section 112.054(b) provides that a court must consider spendthrift provisions as a factor in making its decision whether to modify or terminate, but the court is not precluded from exercising its discretion to modify or terminate solely because the trust is a spendthrift trust. This provision is important because most irrevocable trusts include spendthrift provisions. Absent this statutory language, it would not be unexpected for a court to conclude that the grantor did not want the beneficiaries to have the power to deal with and/or receive the trust property prior to the time for distribution under the trust instrument. Under the statute, the court should consider the spendthrift provision as a factor, but its inclusion is not an automatic bar to modification or termination.

(v) Virtual Representation and Related Issues. It is often difficult or impossible to get all beneficiaries before the court. Beneficiaries who are minors, incapacitated, unborn or unascertained cannot themselves participate in a judicial modification or termination proceeding. Trustees and other persons interested in the trust are understandably reluctant to take actions involving the trust which do not bind these beneficiaries. One alternative is to have a guardian of the estate or a guardian ad litem appointed for such persons. *See* TEX. PROP. CODE §§ 112.054(d); 115.014(a); 115.013(c)(2)(A). Fortunately, Section 115.014(c) of the Trust Code now permits a guardian ad litem to "consider general benefit accruing to the living members of a person's family" in deciding how to act. This makes it easier to obtain guardian ad litem approval to a modification that provides no direct benefit to minor or unascertained beneficiaries but which benefits the family (and, presumably, the minor or unascertained members of the family) generally. In addition, under Section 115.013(c) of the Texas Trust Code, if there is no conflict of interest and if no guardian of the estate or guardian ad litem has been appointed, a parent may represent his minor child as guardian ad litem or as next friend. Also, an unborn or unascertained person who is not otherwise represented is bound by an order to the extent his interest is adequately represented by another party having a substantially identical interest in the proceeding.

While this statutory statement of "virtual representation" is limited to parents acting for their minor children and other beneficiaries acting for unborn or unascertained persons, the cases do not appear to limit virtual representation to minors and unborns. *See, e.g., Mason v. Mason*, 366 S.W.2d. 552 (Tex. 1963) (doctrine of virtual representation not limited to beneficiaries representing other beneficiaries where trustee was found to have virtually represented the beneficiaries in suit challenging the validity of the trust). In short, Section 115.013(c) (together with the necessary parties statute–Section 115.011) provides a safe harbor in most cases where trust modification or termination is sought. If all of the necessary parties described in Section 115.011 can be served or otherwise brought into the suit, if all minors can be represented by their parents without a conflict of interest, and if the interests of all unborn or unascertained persons are adequately represented by another party having a substantially identical interest, then a guardian ad litem generally can be avoided and the parties can have a moderate level of comfort that the modification or termination order will be binding on all beneficiaries. If some or all of these requirements cannot be met, then one or more ad litems probably are necessary under Section 115.014.

(vi) No Justiciable Controversy Required. Proceedings under Section 112.054 do not require a justiciable controversy. *Gregory v. MBank Corpus Christi, N.A.*, 716 S.W.2d. 662 (Tex. App.—Corpus Christi 1986, no writ). Therefore, a modification or termination suit is not subject to attack merely because there is no actual controversy before the court.

3. Trust Divisions, Combinations and "Mergers" Under the Texas Trust Code. If the substance of a trust instrument is acceptable, but the administrative provisions are problematic, an alternative to a modification action under Section 112.054 might be to seek a trust combination, or "merger." Section 112.057 of the Texas Trust Code was amended in 2005 to give trustees broader authority (without judicial intervention) to divide and combine trusts. Prior to the 2005 amendment, the Trust Code authorized a trustee to merge trusts only if the trusts had "identical terms" and only if the trustee determined that the merger would result in significant tax savings. *See* former TEX. PROP. CODE § 112.057(c). In 2005, the legislature adopted language based on the Uniform Trust Code, which gives the trustee significantly broader authority to combine trusts Although this combination of trusts is often referred to as "merging" two trusts, the revised statute uses the term "combine," perhaps (i) to avoid confusion of the common law notion of merging interests, the effect of which is to terminate a trust (*See* TEX. PROP. CODE § 112.034); and (ii) to avoid any suggestion that the trusts may be combined without income tax effects (*See* I.R.C. § 368(a)(1)(A), describing tax-free mergers of corporations).

a. *No Impairment*. The statute now requires that the trustee show the divisions or the combination of the two trusts will not "impair the rights of any beneficiary or adversely affect achievement of the purposes of one of the separate trusts." TEX. PROP. CODE § 112.057(c). The Trust Code does not define what constitutes impairing the rights of a beneficiary. The drafters of the Uniform Trust Code, which contains similar language, expressed the notion this way:

> Typically the trusts to be combined will have been created by different members of the same family and will vary on only insignificant details, such as the presence of different perpetuities savings periods. The more the dispositive provisions of the trusts to be combined differ from each other the more likely it is that a combination would impair some beneficiary's interest, hence the less likely that the combination can be approved.

Unif. Laws. Ann. (UNIF. TRUST CODE) § 417 comment (2006).

b. *No Consent Required*. If the trustees of the two trusts determine that the trusts can be combined (or if he trustee determines it can divide a trust), they may do so without the consent of the beneficiaries, but must give notice of the combination or division to the beneficiaries not later than thirty days prior to the effective date of the combination or division. TEX. PROP. CODE § 112.057(c)(1). Beneficiaries that must be given notice are those who are entitled to receive distributions or will be entitled to distributions once division or combination is complete, although they may waive such notice.

c. *Two-Step Decanting*. In Private Letter Ruling 200451021, the IRS ruled that no adverse income, gift, or GST tax consequences would occur when state law and the trust agreement permitted a division of trusts into separate trusts followed by the immediate merger of the separate trusts with other, existing trusts. The facts of the ruling indicate that the trustee proposed to partition each GST-exempt trust into two trusts, subject to court approval, with each trust holding a different type of asset. One of these new trusts would then merge into an existing trust which had the same terms and benefitted the same beneficiaries. The Service ruled that neither the partition of each trust nor the merger of any of the trusts would cause a GST-tax to be imposed, no gain or loss would be realized, and the merged trusts would receive a carryover basis and holding period in the assets that each received. In addition, the IRS ruled that the partition of the trusts was a qualified severance, so the new trusts would retain their zero inclusion ratio for GST-tax purposes.

4. Reformation and Rescission. Reformation and rescission suits are similar to modification and termination suits, but the basis for the suit is different.

a. Reformation. Reformation suits are based on mistakes of fact at the inception of the trust, not deviation from the trust terms due to changed circumstances. If, due to a mistake in the drafting of the trust instrument, the instrument does not contain the terms of the trust as intended by the grantor and trustee, the grantor or other interested party may maintain a suit in equity to have the instrument reformed so that it will contain the terms which were actually agreed upon. Bogert, TRUSTS AND TRUSTEES (2nd ed.) § 991. Most courts have held that reformation must be based upon a mistake of fact, not a mistake of law. *See, e.g., Community Mut. Ins. Co. v. Owen,* 804 S.W.2d. 602 (Tex. App.—Houston [1st Dist.] 1991, writ denied). However, this limitation on reformation has usually been applied to mistakes of fact regarding the general rules of law, and not to a mistake regarding particular private legal rights and interests. In other words, if parties contract under a mutual mistake and misapprehension as to their specific rights, the agreement may be set aside as having proceeded upon a common mistake. *Furnace v. Furnace,* 783 S.W.2d. 682, 686 (Tex. App.—Houston [14th Dist.] 1989, writ dismissed w.o.j). In *Furnace,* for example, the parties were mistaken as to what effect a sale would have on their interests in a trust. Dicta in the opinion indicates that this was a mistake of fact, not of law, even though legal interpretations of instruments were involved. (Despite the dicta, the court of appeals in *Furnace* found that the parties waived this issue by failing to submit it at trial.) In addition, courts in other jurisdictions have extended the doctrine of reformation to mistakes of law made by the scrivener of the trust agreement, where the grantor relied on the scrivener and could not reasonably be expected to have known the legal implications of language in the trust agreement. *See Carlson v. Sweeney*, 895 N.E.2d. 1191 (Ind. 2008). *See also Loeser v. Talbot*, 589 N.E.2d. 301, 412 Mass. 361 (1992) (trust may be reformed to effect grantor's clearly stated intent to save generation-skipping transfer taxes); *Cf. duPont v. Southern Nat'l Bank of Houston*, 575 F.Supp. 849 (S. D. Tex. 1983), aff'd in part, vacated in part, on other issues 771 F.2d. 849 (5th Cir. 1985) (insufficient evidence that the grantor would not have created the trust but for his alleged mistake as to tax consequences).

b. Rescission. If a grantor never intended to create a trust, then rescission is the proper remedy. Recission is a remedy provided by common law. In *Wils v. Robinson*, 934 S.W.2d. 774 (Tex. App.—Houston [14th Dist.] 1996), judgment vacated without reaching merits 938 S.W.2d. 717 (Tex. 1997), the court of appeals found that Section 112.054(a)(2) of the Texas Trust Code was not a basis for terminating a trust which the grantor said he never intended to create. Rather, rescission was the proper remedy, based on mistake, fraud, duress or undue influence. 934 S.W.2d. at 779.

5. Modification or Termination by Agreement of Grantor and Beneficiaries. If a grantor of a trust is alive and all of the beneficiaries of an irrevocable spendthrift trust consent (and if there is no incapacity to consent by any of the parties), the grantor and all of the beneficiaries may consent to a modification or termination of the trust. *Musick v. Reynolds*, 798 S.W.2d. 626 (Tex. App.—Eastland 1990, no writ); *Becknal v. Atwood*, 518 S.W.2d. 593 (Tex. Civ. App.—Amarillo 1975, no writ); and *Sayers v. Baker*, 171 S.W.2d. 547 (Tex. Civ. App.—Eastland 1943, no writ). Texas case law appears to make no provision that the trustee consent or even be a party to the agreement to modify or terminate a spendthrift trust. In contrast, Section 112.051(b) of the Texas Trust Code provides that the grantor of a trust may modify or amend a trust that is revocable, but the grantor may not enlarge the duties of the trustee without the trustee's express consent. The necessity of obtaining the trustee's consent before enlarging the trustee's duties is certainly proper. One can only assume that a modification of a trust must not enlarge the duties of a trustee, or the trustee must be made a party. There are two serious practical impediments to modifying or terminating a trust by agreement of the grantor and all beneficiaries. First, the grantor often is dead, rendering this method ineffective. Second, the concept of virtual representation available in judicial proceedings to modify or terminate trusts does not appear to be available, and all too often there are minor or contingent beneficiaries who cannot enter into the agreement.

V. STATUTORY DECANTING.

A. "Decanting." Decanting statutes allow a trustee with discretionary distribution authority over a trust, in effect, to modify the trust's terms and conditions by pouring trust assets into a new trust with, for example, more or less restrictive dispositive provisions, different successor trustees, different governing law provisions, etc. Decanting is the next step in the evolution of trust law where it is becoming clearer that for trusts, "irrevocable" does not mean "unchangeable."

Several states (not yet including Texas), permit a trustee who has discretion to make distributions to or for the benefit of the beneficiary to make a distribution into a new trust for that beneficiary. New York, in 1992, was the first state to enact a decanting statute. In 2005, the Texas legislature adopted a very limited version of this ability to "decant" from one trust to another. Section 113.021(a) of the Texas Trust Code provides that a trustee who holds property for a beneficiary who is "a minor or a person who in the judgment of the trustee is incapacitated by reason of legal incapacity or physical or mental illness or infirmity" may retain trust property as a separate trust on the beneficiary's behalf. Several states (starting with Delaware, New York and Alaska, but recently including Tennessee, Florida, South Dakota and others) have broadened this authority to enable a trustee to distribute or "decant" assets from an old "bad" trust into a new "good" trust. *See* Wareh, "Trust Remodeling," TRUSTS & ESTATES (August, 2007), 18. Currently, sixteen states have adopted decanting statutes. These states are Alaska, Arizona, Delaware, Florida, Illinois (effective 01/01/2013), Indiana, Kentucky (effective 07/12/2012), Missouri, Nevada, New Hampshire, New York, North Carolina, Ohio, South Dakota, Tennessee, and Virginia (effective 07/01/12). The Michigan senate has passed a decanting statute and it is currently under consideration by its house. Although Colorado has a decanting statute under consideration, opposition from members of the state bar may spell its demise. The following discussion is meant to give a fairly detailed overview of the various state statutes, but by no means is it meant to be an exhaustive analysis.

1. Decanting by Trustee. Typically, it is the trustee who must have the ability to decant. Some statutes prohibit or limit a trustee from having the power to decant if the trustee is also a beneficiary. MO. REV. STAT. § 456.4-419(2)(2); N.H. REV. STAT. ANN. § 564-B:4-418(c); N.C. GEN. STAT. § 36C-8-816.1(d); S.D. CODIFIED LAWS § 55-2-15(2); VA. CODE ANN. § 55-548.16:1(D).

2. Applying State Law. Of course, if a trust is governed by a state that has a decanting statute and the trust agreement does not prohibit decanting, the state's statute will apply. Most states also provide that its decanting statute will apply to a trust that moves its situs to that state. ALASKA STAT. § 13.36.157(b); ARIZ. REV. STAT. ANN. § 14-10819(B); MO. REV. STAT. § 456.4-419.6; N.Y. E.P.T.L. §10-6.6(r); OHIO REV. CODE § 5808.18(O); S.D. CODIFIED LAWS § 55-2-15(2); VA. CODE ANN. § 55-548.16:1(K).

Back to Table of Contents

So, is decanting available to Texans? Currently, the Texas Trust Code does not have an express statute allowing decanting (although decanting may effectively be permitted under common law). Absent a prohibition in the trust agreement, commentators suggest that anyone can decant, simply by evoking the law of a state with favorable decanting rules. While a trustee cannot simply choose to apply the law of a state to which the trust has no nexus, it may be fairly easy to establish the required nexus. See, however, discussion below regarding choice of law issues at V.A.12. The most common approach is to seek appointment of a corporate fiduciary with offices in the desired state. Therefore, for example, if a Texas trust permits (or does not prohibit) a change in situs, it could be possible to first move the situs of the trust to a state with a desired decanting statute, and then decant. Statutory decanting can give a trustee greater certainty regarding authority to and the procedure for decanting. A trustee may find even greater comfort when transferring situs in order to decant if the law of the new state specifically provides that it will apply to a new trust that has moved its situs to that state.

3. Decanting as Exercise of Power of Appointment. The earlier decanting statutes are generally an extension of the common law, which has typically provided that, absent limitations imposed by the grantor, a power of appointment held by a trustee (including a simple right to make discretionary distributions) includes the authority to make distributions subject to such terms and conditions as the trustee may desire. RESTATEMENT (2D) OF TRUSTS § 19.3, Note 3 (1986). See also SCOTT ON TRUSTS § 17.2 (4th Ed., 2001); 94 ALR 3rd 895.Most statutes specifically provide that the trustee's authority to decant is considered the exercise of a power of appointment. ALASKA STAT. § 13.36.157(c); ARIZ. REV. STAT. ANN. § 14-10819(C); DEL. CODE ANN. tit. 12, § 3528(c); FLA. STAT. ANN. § 736.04117(3); IND. CODE § 30-4-3-36(d); KY. § 386.175(2); NEV. § 163.556(8); N.Y. E.P.T.L. § 10.606(d); N.C. GEN. STAT. § 36C-8-816.1(e)(1); S.D. CODIFIED LAWS § 55-2-19; VA. CODE ANN. § 55-548-16.1(E)(2).

4. Source of Trustee's Authority. Most state statutes allow a trustee to decant if the trustee has authority to invade principal, although some require, at least in the case of decanting other than for administrative changes, that the trustee have "absolute" power or discretion to invade principal which means that the power cannot be limited by an ascertainable standard. FLA. STAT. §736.04117(1)(a); IND. CODE §30-4-3-36(a); OHIO REV. CODE § 5808.18(A)(1). Illinois allows broader decanting power if the trustee has absolute discretion and limited decanting power if the discretion is limited. 760 ILCS §§5/16.4(c), (d). If decanting authority is limited to an ascertainable standard, theoretically, there are certainly situations that would justify decanting a trust for reasons of health, education, maintenance, or support. Other states just require that the trustee have some authority to invade principal. ALASKA STAT. §13.36.157(a); ARIZ. REV. STAT. ANN. § 14-10819(A); S.D. CODIFIED LAWS § 55-2-15; TENN. CODE ANN. § 35-15-816(b)(27)(A). South Dakota requires that the trustee consider whether the appointment is necessary or desirable after taking into account the purposes of the original trust, the terms and conditions of the new trust, and the consequences of making the distribution. S.D. CODIFIED LAWS § 55-2-15.

The trustee must have the power to decant either pursuant to the trust agreement or state law and such power must be within the trustee's fiduciary duties, including the duty of loyalty. Of course, state law would include common law of the relevant jurisdiction. If the trust agreement expressly prohibits decanting, then the trustee will not be able to act. Including such a prohibition in the agreement can be important for clients who want to severely limit the ability to change the terms of the trust. As with any trust, the trust agreement should be reviewed to determine whether the agreement outlines the procedures for decanting. If not, then state law should be reviewed.

5. What the Trustee Can Decant. All states that have enacted decanting statutes allow decanting of trust principal. Some states limit decanting to trust principal. ALASKA STAT. § 13.36.157(a); DEL. CODE ANN. tit 12, §3528(a); FLA. STAT. ANN. § 736.04117(1)(a); 760 ILCS §§5/16.4(c), (d); IND. CODE § 30-4-3-36(a); N.Y. E.P.T.L. §10-6.6(b); TENN. CODE. ANN. § 35-15-816(b)(27)(A). The trend, however, appears to be to allow decanting of both trust principal and income. ARIZ. REV. STAT. ANN. § 14-10819(A); KY. § 386.175(2); MO. REV. STAT. § 456.4-419.1; NEV. REV. STAT. § 163.556(1); N.H. REV. STAT. ANN. § 564-B:4-418(a); N.C. GEN. STAT. § 36C-8-816.1(b); OHIO REV. CODE § 5808.18(A)(1); S.D. CODIFIED LAWS § 55-2-15; VA. CODE ANN. § 55-548.16:1(B).

6. Permissible Beneficiaries of New Trust. As a general rule, at least some of the beneficiaries of the original trust must be named in the new trust. In identifying who the beneficiaries of the new trust may be, the trustee must determine the beneficiaries of the old trust. A few states have used the term "proper objects of the exercise of the power" to describe who may be permissible beneficiaries of the new trust.[1] DEL. CODE ANN. tit. 12, § 3528(a)(1); N.Y. E.P.T.L. § 10-6.6(b)(1); TENN. CODE ANN. § 35-15-816(27)(A)(ii). Presumably, this would include future and contingent beneficiaries of the old trust. Most states, however, simply use the term "beneficiaries" or "current beneficiaries." ALASKA STAT. § 13.36.157(a)(2); ARIZ. REV. STAT. ANN. § 14-10819(A)(3); FLA. STAT. ANN. § 736.04117(1)(a)(1); 760 ILCS §§5/16.4(c), (d); IND. CODE § 30-4-3-36(a)(1); KY. § 386.175; NEV. REV. STAT. § 163.556(1); N.H. REV. STAT. ANN. § 564-B:4-418(a); N.C. GEN. STAT. §§ 36C-8-816.1(b), (c); VA. CODE. ANN. § 55.548.16:1(B). Some states, such as Nevada, New Hampshire and North Carolina, specifically provide that the new trust may not include a beneficiary who is not a beneficiary of the old trust. Interestingly, some states provide that the terms of the new trust may contain a power of appointment, so it would presumably be possible to then add beneficiaries to the trust. DEL. CODE ANN. tit. 12, § 3528(a); 760 ILCS §5/16.4(c) (if trustee has absolute discretion); KY. § 386.175(4)(i); NEV. REV. STAT. § 163.556(6)(a); N.C. GEN. STAT. § 36C-8-816.1(c)(8); VA. CODE ANN. § 55-548.16:1(C)(8). Of course, any potential tax effects from the inclusion or exercise of such a power would need to be considered.

7. Tax Savings Provisions. Tax savings provisions are commonly found in the statutes. Many states include provisions to prevent loss of a marital or charitable deduction for federal or state tax purposes if the old trust qualified for the deduction. FLA. STAT. ANN. § 736.04117(1)(a)(3); 760 ILCS §5/16.4(p); IND. CODE § 30-4-3-36(a)(3); KY. § 386.175(4)(d); NEV. REV. STAT. § 163.556(2)(c); N.H. REV. STAT. ANN. § 564-B:418(B)(3); N.C. GEN. STAT. § 36C-8-816.1(c)(4); N.Y. E.P.T.L. § 10-6.6(n)(5); OHIO REV. CODE § 5808.18(C)(2); VA. CODE ANN. § 55-548.16:1(C)(5). Ohio and Illinois include a provision that limits the ability to decant a trust that holds S corporation stock if the new trust will cause the stock to be disqualified. OHIO REV. CODE § 5808.18(C)(4); 760 ILCS §5/16.4(p)(2). Arizona goes a step further and provides that decanting is permissible unless it will "adversely affect the tax treatment of the trust, the trustee, the settlor or the beneficiaries." ARIZ. REV. STAT. ANN. § 14-10819(A)(5).

In many states, the current beneficiary's right of withdrawal is a concern. Some statutes limit the ability to decant if a beneficiary has a presently exercisable right of withdrawal,

[1] This language probably derives from the Restatement (Second) of Property: Donative Transfers § 19.3.

and at a minimum, provide that the beneficiary's right will carry over to the new trust. DEL. CODE ANN. tit. 12, § 3528(a)(4); KY. § 386.175(4)(f); MO. REV. STAT. § 456.4-419.2(a)(6); NEV. REV. STAT. § 163.556(2)(d); N.H. REV. STAT. ANN. § 564-B:418(b)(4); N.C. GEN. STAT. § 36C-8-816.1(c)(6); S.D. CODIFIED LAWS § 55-2-15(7); VA. CODE ANN. § 55-548.16:1(C)(7). These statutes help prevent a withdrawal from being found illusory or the beneficiary being treated as having made a gift to the new trust.

8. Other Limitations. Most states provide that the new trust must have a distribution standard as restrictive as or at least as restrictive as the old trust. ALASKA STAT. § 13.36.157(a)(4); ARIZ. REV. STAT. ANN. § 14-10819(A)(4); KY. § 386.175(4)(h); N.C. GEN. STAT. § 36C-8-816.1(c)(7); S.D. CODIFIED LAWS § 55-2-15(2)(b); N.Y. E.P.T.L. § 10-6.6(c)(1); VA. CODE ANN. § 55-546.16:1(C)(2).

Almost every state provides that a trustee is prohibited from decanting a trust if it will reduce a beneficiary's income, annuity or unitrust interest in the old trust. ARIZ. REV. STAT. ANN. § 14-10819(A)(1), (2); FLA. STAT. ANN. § 736.04117(1)(a)(2); 760 ILCS §5/16.4(n)(1); IND. CODE § 30-4-3-36(a)(2); KY. § 386.175(4)(c); NEV. REV. STAT. § 163.556(2)(b); N.H. REV. STAT. ANN. § 564-B:418(b)(2); N.Y. E.P.T.L. § 10-6.6(n)(1); N.C. GEN. STAT. § 36C-8-816.1(c)(3); OHIO REV. CODE § 5808.18(C)(1)(ii); VA. CODE ANN. § 55-548.16:1(C)(4).

It is common for states to provide that a spendthrift provision in the old trust or a provision in the old trust prohibiting the grantor from amending or revoking the old trust are not sufficient to prevent the trustee from being able to decant. FLA. STAT. ANN. § 736.04117(5); 760 ILCS §5/16.4(m); IND. CODE § 30-4-3-36(f); MO. REV. STAT. § 45.4-419.2(7); NEV. REV. STAT. § 163.556(12); N.H. REV. STAT. ANN. § 564-B:418(g),(h); N.Y. E.P.T.L. § 10-6.6(m); OHIO REV. CODE § 5808.18(H); VA. CODE ANN. 55-548.16:1(E)(4).

9. State Specifics. If the trustee does not have the absolute power to decant, Ohio law states that the terms of the new trust cannot materially change the interests of the beneficiaries of the old trust. OHIO REV. CODE § 5808.18(B). It appears, then, that if the trustee does not have the absolute power to decant, administrative changes to the trust would still be permissible. Ohio, being one of the newest statutes with an effective date of March 22, 2012, has included more specific language than most other statutes. For example, decanting cannot change a beneficiary's right to annually withdraw a percentage of the trust assets or a specific dollar amount (OHIO REV. CODE § 5808.18(C)(1)(iii)) and decanting cannot change the GST tax exemption status of the old trust (OHIO REV. CODE § 5808.18(C)(5)).

In Kentucky, the statute specifically provides that decanting cannot be done if the old trust is a charitable remainder trust. KY. § 386.175(9). Illinois prevents a trustee from decanting solely to change the compensation of the trustee, unless a court authorizes otherwise. 760 ILCS §5/16.4(q).

At least three states expressly provide that a trust can be decanted to a "supplement needs" or "special needs" trust. 760 ILCS §5/16.4(d)(4) (special power when trustee does not have absolute discretion); N.Y. E.P.T.L. § 16-6.6(n)(1); VA. CODE ANN. § 55-548.16:1(C)(9).

10. Duty to Decant? Fiduciary duties are always a concern of every trustee. The more recent state statutes include language clarifying that a trustee is not obligated or under a duty to decant. FLA. STAT. ANN. § 736.04117(6); 760 ILCS §5/16.4(l); IND. CODE § 30-4-3-36(g); KY. § 386.175(8); MO. REV. STAT. § 456.4-419.5; NEV. REV. STAT. § 163.556(10); N.H. REV. STAT. ANN. § 564-B:418(f); OHIO REV. CODE § 5808.18(J) (if trustee acts reasonably and in good faith, presumed to have acted according to terms and purposes of trust and in interests of beneficiaries); N.Y. E.P.T.L. § 10-6.6(l) (if decant, must be in best interests and as a prudent person would); N.C. GEN. STAT. § 36C-8-816.1(g); VA. CODE ANN. § 55-548.16:1(H). For states without decanting statutes but where common law allows decanting, a trustee may have a fiduciary duty to decant, when appropriate.

11. Procedural Requirements. Most states require that the decanting be in writing, signed and acknowledged by the trustee, and maintained as part of the records of the trust. DEL. CODE. ANN. tit. 12, § 3528(b); FLA. STAT. ANN. § 736.04117(2); 760 ILCS §5/16.4(r); IND. CODE § 30-4-3-36(c); KY. § 386.175(7)(a); NEV. REV. STAT. § 163.556(7); N.Y. E.P.T.L. § 10-6.6(j); N.C. GEN. STAT. § 36C-8-816.1(f)(1); OHIO REV. CODE § 5808.18(D); S.D. CODIFIED LAWS § 55-2-18; TENN. CODE ANN. § 35-15-816(b)(27)(B); VA. CODE ANN. § 55-548.16:1(F). Even if these requirements are not set out by statute, it seems prudent that the trustee take steps to document the decanting in writing, in a manner that may, if necessary, be made a matter of public record (for example, by an acknowledged instrument in recordable form). Any such writing should be maintained with the records of the trust.

The only state that requires court approval is Ohio, and even in that case, the circumstances are narrow. If the trust being decanted is a testamentary trust and the decedent was domiciled in Ohio at death, the trustee must get court approval of the decanting. OHIO REV. CODE § 5808.16(K). Illinois allows the trustee or a beneficiary to seek court involvement under certain circumstances. 760 ILCS §5/16.4(k). Notice that since the grantor is dead, there may be fewer tax concerns with the decanting, at least from an income tax standpoint. But for one narrow exception, no state requires the trustee to obtain beneficiary consent, although most states require the trustee to at least give notice to the beneficiaries prior to decanting. FLA. STAT. ANN. § 736.04117(4); 760 ILCS §5/16.4(e); IND. CODE § 30-4-3-36(e); KY. § 386.175(7)(b); MO. REV. STAT. § 456.4-419.3; N.C. GEN. STAT. § 36C-8-816.1(f); N.Y. E.P.T.L. § 10-6.6(j)(2) (also requiring notice to others); OHIO REV. CODE § 5808.18(F); S.D. CODIFIED LAWS § 55-2-18; VA. CODE ANN. § 55-548-16:1(G) (also requiring notice to others). In Nevada, if trust property is designated for a specific beneficiary pursuant to the terms of the old trust but after decanting, the property will no longer be designated for that beneficiary, the trustee must obtain consent. NEV. REV. STAT. § 163.556(2)(e).

12. Choice of Law Issues. When decanting involves changing the situs of a trust, choice of law issues must be considered. The Restatement (Second) of Conflict of Laws ("Conflict Restatement") provides that when construing or administering a trust holding personal property, the law of the state designated in the trust agreement controls. RESTATEMENT (2D) OF CONFLICT OF LAWS: TRUSTS §§ 268(1), 272(a) (1971). The designated state's law will apply as long as the state has a substantial relationship to the trust and its law does not violate any strong public policy of the state with which the trust has the most significant relationship. *Id*. at 270(a). The law governing the construction of a trust and for the administration of a trust may be different. According to the Conflict Restatement, if the trust is silent as to the law governing the construction of the trust, the trust may be construed based on a number of different laws, including the law of the state governing the administration of the trust, the law of the trust's domicile, the law of the state with which the grantor had the most contacts, or even the law that the grantor would believe to apply, such as where the grantor was domiciled. *Id*. at 268(2), 270(b), 272(b).

Back to Table of Contents

VI. TAX ISSUES IN DECANTING AND TRUST MODIFICATIONS.

A. General Tax Issues. The foregoing discussion focused primarily on the state law issues surrounding trust modifications and decanting. Equally important are the tax issues which might arise. As mentioned above, “decanting” is not defined in the Internal Revenue Code or Treasury regulations. Since Notice 2011-101 was issued, comments have been submitted to the IRS by several organizations, including ACTEC, ABA’s Section of Taxation, the State Bar of Texas Tax Section, the New York State Bar’s Tax Section, and Bessemer Trust. Prior to issuance of the Notice, the IRS issued Rev. Proc. 2011-3 and placed decanting on its “no-ruling” list for specific income, gift, and GST-tax issues. At this time, no date has been given by the IRS as to when published guidance can be expected. Until the IRS publishes guidance and case law develops, following is a discussion of potential tax issues that practitioners should consider when advising client about decanting or trust modification.[2]

1. Income Tax Issues. In most cases, decanting from one trust to another, trust modifications, and trust combinations should present minimal, if any, tax consequences to the trust or the trust beneficiaries. For a general discussion of income tax issues associated with trusts, see Davis, "Income Taxation of Trusts and Estates," 33rd Annual State Bar of Texas Adv. Est. Planning & Prob. Law Course (2009).

a. _Distributions and DNI_. If trust assets are decanted from one trust to another trust, one possibility is that the decanting will be treated as a trust modification rather than a termination so that both trusts will be treated as the same trust for income tax purposes with no income tax consequences to either trust. This view is supported by the IRS in Private Letter Ruling 200736002. *See also*, PLRs 200723014 and 200607015.

A second possibility follows the general rule that any distribution from a trust will carry with it a portion of the trust's distributable net income ("DNI"). I.R.C. §§ 651, 661. Trust distributions are generally treated as coming first from the trust's current income, with tax-free distributions of "corpus" arising only if distributions exceed DNI. If distributions are made to multiple beneficiaries, DNI is allocated to them pro rata. If a trust terminates, current income is carried out, as are any unused capital losses, net operating losses, and expenses incurred in excess of income. I.R.C. § 642(h). Thus, when two trusts combine or "merge," no provision of the Code provides that the combination of trusts is tax-free. Therefore, the treatment may be that the terminating trust will be treated as making a terminating distribution, carrying out its DNI, unused losses, and excess deductions, to the surviving trust. In other words, the result would be that the new trust would receive taxable income to the extent of the old trust’s DNI and the old trust would receive a corresponding distribution deduction.

b. _Grantor Trusts_. Grantor trust treatment for income tax purposes is determined pursuant to Subpart E of Subchapter J of the Internal Revenue Code. Trust property held in a grantor trust is treated as being owned by the grantor for federal income tax purposes. A transfer of trust property from one grantor trust to another grantor trust should have no federal income tax effect. It has long been the rule in the case of sales transactions between a grantor and a grantor trust that no federal income tax effect will result. Rev. Rul. 85-13, 1985-1 C.B. 184. More recently, in Revenue Ruling 2007-13, the IRS made it clear that if a life insurance policy held by

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[2] This outline discusses tax issues from a federal standpoint. Advisors, however, should also consider any state tax issues that may arise. In addition, decanting a domestic trust to a foreign trust or vice versa is beyond the scope of this outline.

a grantor trust is transferred to another grantor trust, the grantor will be treated as the owner of the policy for the transfer for value rules so that no negative income tax consequences will result. Rev. Rul. 2007-13, 2007-11 I.R.B. 684. It would seem to follow that the act of transferring, "merging," or decanting the assets of a grantor trust to another grantor trust, which is merely a transfer of assets, should have no income tax effect.

When a grantor trust loses its grantor trust status, the grantor is treated as having transferred ownership of the trust property to the trustee of the trust, and a taxable disposition of the trust property by the grantor occurs. *Madorin v. Comm'r*, 84 T.C. 667 (1985); Rev. Rul 77-402, 1977-2 C.B. 222; Treas. Reg. § 1.1001-2(c), Ex. 5. The fact that a disposition of trust property occurs does not necessarily mean that the disposition has any affect for federal income tax purposes. Rather, as the court made clear in *Madorin*, the grantor trust rules operate to determine whether the grantor is the owner of the trust property for federal income tax purposes, but other provisions of the Internal Revenue Code, such as the partnership tax rules, must be reviewed to determine if there is any federal income tax effect upon a disposition of the trust property.

Therefore, the mere transfer from a grantor trust to a non-grantor trust through decanting or otherwise should not, in and of itself, cause a realization event for federal income tax purposes. Instead, provisions of the Internal Revenue Code other than the grantor trust tax rules may cause a realization event for federal income tax purposes.

In contrast, if a non-grantor trust becomes a grantor trust through decanting or otherwise, there should be no realization event. Rev. Rul. 85-13, 1985-1 C.B. 184. By their terms, Sections 671 through 677 of the Code can cause a trust that is a non-grantor trust at one point in time to be treated as a grantor trust at a later time. The portion rules in these sections are examples of such events. For example, if a trust allows the use of trust income to pay premiums on life insurance policies insuring the life of the grantor or the grantor's spouse, to the extent the premiums are so used, that portion of the trust will be a grantor trust. I.R.C. § 677(a). In addition, marriage is enough to make an otherwise non-grantor trust become a grantor trust. For example, a trust that allows distributions of income to a grantor's friend does not make the trust a grantor trust, but if the grantor marries the friend, the trust will then be treated as a grantor trust. I.R.C. § 677(a). If a grantor establishes a trust, names his friend as trustee, and gives broad discretionary authority regarding distributions to the trustee, the trust is not a grantor trust. If the grantor subsequently marries the trustee, the trust will then become a grantor trust. I.R.C. § 672(e). As shown by these examples, and as can be seen throughout the grantor trust rules, relatively benign actions can cause an otherwise non-grantor trust to become a grantor trust. In addition, in Chief Counsel Advice 200923024, the IRS ruled that for federal income tax purposes, the conversion of a non-grantor trust to a grantor trust is not a transfer of property held by the non-grantor trust to the owner of the grantor trust that requires the recognition of gain to the owner. Based on the foregoing, the mere act of a conversion from a non-grantor trust to a grantor trust through decanting should not cause a federal income tax realization event.

c. *Gains*. Treasury Regulation Section 1.1001-1(a) provides that gain from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income. The issue then is whether property is sold or disposed of in exchange for property that is materially different. In *Cottage Savings Ass'n v. Comm'r*, 499 U.S. 554 (1991), the Supreme Court found that properties are materially different if their owners "enjoy legal entitlements that are different in kind or extent." *Id* at 555. In certain situations, the IRS might argue that a decanting or trust modification may be treated as a distribution followed by an exchange of interests among the beneficiaries, resulting in recognized gain for income tax purposes. *See* Rev. Rul. 69-486, 1969-2 C.B. 159.

In Private Letter Ruling 200231011, the taxpayer asked the IRS to rule about the tax consequences of a proposed trust modification. Under the terms of a testamentary trust, the testator's grandson was to receive a fixed dollar amount each year during his life, with the remainder interest passing to various charities. The trust was later restructured to provide for annual income distributions in accordance with a performance chart. Subsequently, disputes arose regarding the administration of the trust. Under the terms of a settlement, the charities would receive an immediate distribution of corpus in termination of their interest. The remaining amount would continue in trust for the grandson, providing a 7% unitrust amount, plus distribution of principal as needed for his reasonable support. On his death, the remaining corpus would be distributed in accordance to the grandson's general testamentary power of appointment. The IRS, citing *Cottage Savings Ass'n v. Comm'r*, 499 U.S. 554 (1991), ruled that an exchange of property results in the realization of gain or loss under Section 1001 of the Code if the properties exchanged are materially different. The IRS then compared the proposed modification to the modifications in two other cases. The first case, *Evans v. Comm'r*, 30 T.C. 798 (1958), involved the exchange of an income interest in a trust for an annuity which the court concluded was a realization event. The second case, *Silverstein v. U. S.*, 419 F.2d. 999 (7th Cir. 1969), found that the exchange of an interest in a trust for a right to specified annual payments from the remainder beneficiary did not result in a realization event because the taxpayer was to receive the same annual payments from the remainderman as she had been receiving from the trust. The IRS determined that the proposed settlement at issue more closely resembled the situation in *Evans* than in *Silverstein* because grandson was currently entitled to trust income subject to a floor and ceiling, but under the proposed settlement he would receive annual unitrust payments and could receive additional discretionary distributions. The IRS stated, "[e]ven assuming that the projected payments under the proposed order approximate those that would be made under the current terms of the trust, under the proposed order Grandson would lose the protection of the guaranteed minimum annual payments required" under the current terms of the trust. He also would not be limited by the maximum annual payment ceiling and payments would be determined without regard to trust income. Therefore, the grandson's interest in the modified trust would entail legal entitlements different from those under the current trust agreement, and as a result, the modification would be treated as a realization event for federal income tax purposes. *See also*, PLR 200736002 (finding division of trust into three separate trusts on a pro rata basis did not result in gain or loss because new trusts were not materially different, even though trustees would be different in the new trusts).

In Private Letter Ruling 200743022, the IRS considered whether decanting assets from old trusts to new trusts and the merger of trusts assets would cause gain or loss recognition in a situation where both state law and the trust agreement authorized the decanting. Because the decanting was to occur as a result of the discretionary authority of the trustees based on state law and the trust agreement and not as a result of the beneficiaries' exchange of trust property, the IRS ruled that no gain or loss would be recognized by any of the trusts or the beneficiaries. The exercise of the trustees' discretionary authority and the lack of involvement by the beneficiaries prevented an analysis pursuant to Section 1001 of the Code.

d. <u>*Basis Disregarded*</u>. If Section 1001 of the Code applies due to the beneficiary's involvement in the decanting or modification, that Section provides a special rule for determining gain or loss from the disposition of a term interest in property. Under Section

1001(e), in determining gain or loss from the disposition of a term interest, generally, the adjusted basis of the interests determined under Code Sections 1014 (inheritance), 1015 (gift) or 1041 (transfers between spouses) is disregarded. A "term interest in property" for purposes of Section 1001(e) means a life interest, an interest for a term of years, or an income interest in a trust. I.R.C. § 1001(e)(2). An exception to this rule applies where the sale or disposition is part of a transaction in which the entire interest in property is transferred. I.R.C. § 1001(e)(3). In Private Letter Ruling 200231011 (discussed above), after concluding that the grandson's interest as modified would entail different legal entitlements from those he possessed under the original agreement thus resulting in gain recognition, the IRS went on to explain that, under Section 1001(e)(1) of the Code, the portion of the adjusted uniform basis assigned to the grandson's interest in the trust is disregarded because it was a term interest. Accordingly, the grandson was required to recognize gain on the entire amount received.

e. Negative Basis Assets. For beneficiaries, because of Section 1001 of the Code and *Crane v. Comm'r*, 331 U.S. 1 (1947), a concern may arise if a trustee decants property that has debt in excess of its basis or an interest in a limited partnership or limited liability company with a negative capital account. In *Crane*, the taxpayer sold property that was subject to nonrecourse debt. The Supreme Court held that the amount realized on the sale included not only any cash or other property received, but also the amount of taxpayer's debt that was discharged as a result of the sale. In the partnership context, Section 752(d) of the Code provides that when a taxpayer sells a partnership interest, any partnership liabilities are treated the same as any other liabilities in the context of a sale or exchange of property. In the trust context, Section 643(e) of the Code provides that upon the distribution of trust property, a beneficiary will receive a carryover basis in the property, adjusted for any gain or loss recognized on the distribution. This Section further provides that gain or loss may be recognized on the distribution, if a trustee elects. Unfortunately, no authority provides an answer as to whether a distribution of trust property that is subject to debt will cause recognition of gain or loss as would be the case with the sale or exchange of other property under *Crane* and related authority or whether no gain or loss would be recognized unless an election is made by a trustee pursuant to Section 643(e).[3] Hopefully, published guidance will answer this question.

2. Gift Tax Issues.

a. General Gift Issues. Can the IRS argue that decanting, trust combinations, and the like give rise to taxable gifts? Section 2512(b) of the Code provides that where a transfer of property is made for less than adequate consideration, the amount in excess of fair consideration will be treated as a gift. The notion that a gift arises as a result of decanting or trust modification may be especially important in situations in which the beneficiary must consent to the change, or where the change results from the settlement of litigation. On the one hand, a transfer of property by an individual in compromise and settlement of threatened estate litigation is a transfer for full and adequate consideration in money or money's worth and, thus, is not a gift for federal gift tax purposes. *See Irma Lampert*, T.C.M. 1184 (1956); *see also Righter v. United States*, 66-2 U.S.T.C. ¶ 1242, 258 F. Supp. 763 (8th Cir. 1966) *rev'd and remanded on other grounds* 68-2 U.S.T.C. ¶ 12554, 400 F.2d 344 (8th Cir. 1968). Private Letter Ruling 8902045 involved a Will contest settlement and considered the issue of whether transfers pursuant to the settlement were subject to the gift tax. The IRS stated that intra-family settlements should not

[3] When transferring assets from a grantor trust to another grantor trust, the basic rule that transfers between two grantor trusts are disregarded for federal income tax purposes should apply.

result in shifts between the parties' economic rights, that the economic values of the parties' claims should be determined "with appropriate allowances for uncertainty," and that "differences may be justified on the basis of compromise." PLR 8902045. On the other hand, where there is no adequate consideration for the settlement agreement, gift tax consequences will arise. *See Nelson v. United States*, 89-2 U.S.T.C. ¶ 13,823 (D.N.D. 1989); PLR 9308032. For example, if a remainder beneficiary agrees to decanting or the termination of a trust and gives up his or her interest in the trust in favor of the income beneficiary, the remainder beneficiary may be treated as having made a gift subject to the gift tax. *See* Rev. Rul. 84-105, 1984-2 CB 197. Commentators have suggested filing a court action as a basis for then having a dispute to settle. It would be important to assess whether a true controversy exists in order to avoid a potential IRS argument of substance over form. The gift tax implication may arise notwithstanding the fact that the value of the foregone interest may be difficult to value. This difficulty in valuing the gift could make it possible to value the gift at a relatively low value. *See* PLR 9451049. In the context of a trust reformation to conform a trust to the grantor's original intent, the IRS has found no gift to have arisen, despite a shift of beneficial interests. *See* PLR 200318064.

Since decanting is based on the discretion of a trustee, gift tax issues can arise if a trust beneficiary is serving as a trustee and exercises the discretion to decant. Treasury Regulation Section 25.2511-1(g)(2) provides that if a trustee is a trust beneficiary and transfers trust property, the transfer will be a taxable gift by the trustee-beneficiary unless the fiduciary power is limited by an ascertainable standard set forth in the trust agreement. Even more certainty is provided in Treasury Regulation Section 25.2511-1(g)(1). The regulation provides that if a trustee distributes property to another beneficiary of the trust and the trustee is not a beneficiary, no taxable gift will occur. Therefore, if a beneficiary is the trustee, the better practice would be to have only an independent trustee exercise discretion to decant. Similarly, if a beneficiary consents to a decanting, such as through providing a receipt and release, an argument exists that the beneficiary is exercising control over the assets which could give rise to a taxable gift. Again, the purpose for the decanting becomes important, such as when the decanting will shift a beneficial interest to different beneficiaries, to determine whether negative tax consequences may result. In a fairly recent private letter ruling, a GST-grandfathered trust was modified to include legally adopted issue and descendants in the definitions of issue and descendants. Under the facts, some of the grantor’s children and grandchildren were legally adopted. The IRS ruled that, as a result of the modification, each issue of the grantor’s child made a gift of their respective future interest in the trust’s income and principal to the adopted issue who were now beneficiaries of the trust. PLR 200917004. Interestingly, the IRS ruled that no loss of the trust’s GST-grandfathered status would occur because the modification did not shift beneficial interests to lower generation beneficiaries or extend the term of the trust. *Id*. Likewise, the concern about gift tax consequences to a beneficiary is especially true in the case of a trust that is set to terminate at a specific date or age and decanting is done to continue the trust. Furthermore, if the beneficiary consents to the decanting, an argument can be made that the beneficiary is a grantor of the new trust pursuant to Treasury Regulation Section 1.671-2(e)(1).

b. *Exercise, Release or Lapse of General Power of Appointment*. The exercise, release or lapse of a general power of appointment is deemed a transfer of property by the individual possessing the power. I.R.C. § 2514(b). To avoid gift tax implications when trusts are decanted or modified, one must determine whether trustees who are also beneficiaries possess general powers of appointment over trust property and whether the decanting or modification of the trust results in the creation, exercise, release or lapse of a general power of appointment.

If a beneficiary of a trust exercises a power of appointment to create a new trust and the termination date of the new trust can be extended beyond the perpetuities period provided in the original trust, the exercise of the power of appointment during the life of the beneficiary may be treated as a taxable gift by the powerholder or at the death of the beneficiary may result in inclusion in the estate of the powerholder. I.R.C. § 2514(d). This is commonly referred to as the "Delaware Tax Trap." Again, if decanting is only exercised by an independent trustee, these issues should not arise. As is common when exercising a power of appointment which results in property passing to a new trust, language may be included in the new trust to prohibit triggering of the Delaware Tax Trap.

3. Estate Tax Issues. Does the grantor run any risks in participating in the decanting or modification of an irrevocable trust, either by agreement or by judicial proceeding? In particular, one might be concerned that the state law basis for decanting or trust modification would be used to find that the grantor somehow retained a power of change or revocation when he or she created the otherwise-irrevocable trust. Treasury Regulation Section 20.2038-1(a)(2) provides, however, that Section 2038 of the Code (power to revoke) does not apply if a power can be exercised only with the consent of all parties having an interest (vested or contingent) in the trust, and if the power adds nothing to the rights of the parties under local law. Therefore, decanting and modifications involving the grantor's participation should not implicate estate tax issues for the grantor. *See* PLRs 200919008; 200919009; 200919010. For beneficiaries, there may be an issue with estate inclusion as described above in the context of the Delaware Tax Trap or if it is shown that the beneficiary had such control over the trust assets as to fall within Sections 2036 or 2038 of the Code. Of course, if the new trust grants a beneficiary a general power of appointment over the trust assets, the assets will be included in the beneficiary's estate pursuant to Section 2041 of the Code.

4. Generation-Skipping Transfer Tax Issues. The GST-tax area is the one area where there is a distinction in the Treasury regulations between powers of appointment and trust decanting. Specifically, the regulations address these differences by providing different safe harbors that may be used to protect the exempt status of grandfathered trusts.

a. <u>*Grandfathered Trusts*</u>. A trust which was irrevocable on September 25, 1985, is exempt from the generation-skipping transfer tax, so long as no additions to or modifications of the trust were made after that date. *See* Treas. Reg. §26.2601-1(b); Tax Reform Act of 1986, Pub. L. No. 99-514, §1433(b)(2)(A), 100 Stat. 2731 (1986). Actual or constructive additions to one of these "grandfathered" trusts make a proportionate amount of distributions from and terminations of interests in property in the trust subject to the GST tax. Examples of constructive additions are the release, exercise, or lapse of a power of appointment. *See* Treas. Reg. §26.2601-1(b)(1)(v). In ruling on GST matters, the IRS generally focuses on whether a trust modification results in a change in the value of interests, in beneficial enjoyment, and/or timing of enjoyment (even an acceleration of the receipt of property by a skip person, which would result in exposing the trust property to transfer taxation more rapidly than if the grandfathered trust held the property for the full term). If such a change occurs, the trust will lose its grandfathered status. *See, e.g.,* PLR 8851017. On the other hand, various administrative changes appear not to jeopardize the grandfathered status. *See, e.g.,* PLR 8902045; PLR 8912038; PLR 9005019; PLR 9849007; PLR 200607015. As a result, one must be extremely careful in modifying or decanting any trust created prior to September 25, 1985. The GST tax implications should be considered before proceeding with any modification or decanting. For an in-depth discussion of this subject, *see* Harrington, "Repairing Generation Skipping Planning Trusts," 21st Annual State Bar of Texas Adv. Est. Planning and Prob. Law Course (1992). *See also* Reis, "Irrevocable or Not? Modifications to Trusts," 33rd Annual State Bar of Texas Adv. Est. Planning & Prob. Law Course (2009).

You will recall that for other purposes, decanting has been likened to the exercise of a power of appointment and many state statutes treat decanting as the exercise of a power of appointment. However, for GST tax purposes, the Treasury regulations make a distinction between decanting (although this term is not used) and special powers of appointment in that different safe harbors are provided for each. For powers of appointment, the regulations focus on whether the exercise of a power of appointment will cause a delay in vesting of a grandfathered trust. Specifically, Section 26.2604-1(b)(1)(v)(B) of the Treasury regulations provides that if the exercise of a power of appointment will delay the vesting of the trust beyond a life in being at the date of the creation of the grandfathered trust plus 21 years or 90 years from the date of creation of the trust, the exercise will be treated as an addition to the trust and the trust will lose its GST exempt status. The key is the exercise of the power of appointment, not the release or lapse of the power. Treas. Reg. § 26.2601-1(b)(1)(v)(B)(1).

For decanting a grandfathered trust, the Treasury regulations have two safe harbors. The first is found in Section 26.2601-1(b)(4)(i)(A) and provides that decanting will not cause a grandfathered trust to lose its GST exempt status if (1) the terms of the trust or local law at the time the trust became irrevocable authorized the trustee to make distributions to a new trust, (2) without the consent or approval of a beneficiary or court, and (3) the terms of the new trust do not extend the vesting of any beneficial interest in a way that would suspend or delay the vesting, absolute ownership, or power of alienation beyond a specific perpetuities period. Since the first state statute was not effective until 1992, which is well after the possible effective date of a grandfathered trust, the trustee would have to look to common law for decanting authority if the trust terms did not authorize the decanting. Note that beneficiary consent and court approval cannot be obtained in order to fall within this safe harbor. In addition, if the requirements of this safe harbor are met, it is possible to use decanting to shift a beneficial interest down generations, as well as up or across generations. Also, it is possible to extend the vesting of the trust for a term longer than that provided in the original trust in contrast to the next safe harbor.

The second safe harbor applicable to decanting is found in Treasury Regulation Section 26.2601-1(b)(4)(i)(D)(1) and provides that a trust modification will not cause a grandfathered trust to lose GST exempt status if the modification (1) is valid under state law, (2) will not shift a beneficial interest to a beneficiary who occupies a generation lower than a beneficiary who held the beneficial interest prior to the modification, and (3) the modification does not extend the time for vesting of a beneficial interest beyond the perpetuities period provided for in the original trust. Unlike the first safe harbor, if the requirements of the second safe harbor are met, the decanting cannot shift a beneficial interest down generations but may only shift beneficial interests up or across generations. However, it may be possible to use a statute for decanting under this safe harbor since there is no requirement that the statute exist at the time that the trust became irrevocable.

Regulations under both safe harbors seem to provide that mere administrative changes to a grandfathered trust through decanting are acceptable and will not cause a loss of grandfathered status. Treas. Reg. § 26.2601-1(b)(4)(i)(D)(1); 26.2601-1(b)(4)(i)(E), Exs. 6 and 10. It seems to follows that if decanting of a trust does not change the grandfathered or GST tax exempt status of either the old trust or the new trust, the inclusion ratio of the old trust should carry over to the new trust.

b. Non-Grandfathered Trusts. The safe harbors provided in the Treasury regulations apply to grandfathered trusts. Although no guidance has been published, the IRS appears to have taken the position that the Treasury regulations applicable to grandfathered trusts should also apply to non-grandfathered trusts. PLR 200743028; PLR 200919008. If this is the case, a decanting that follows the requirements of either of the safe harbors discussed above should preserve the GST exempt status and the inclusion ratio of the old trust should carry over to the new trust. In addition, a decanting or modification that is purely administrative in nature should preserve the GST exempt status.

c. Loss of GST Exempt Status. It is important to carefully work through the issues when decanting or modifying a trust in order to preserve GST exempt status. However, it is unclear what the result will be if GST exempt status is lost. Commentators seem to agree that loss of GST exempt status does not mean that all future distributions from the trust will be subject to GST tax. *See*, Harrington, Plaine & Zaritsky, GENERATION-SKIPPING TRANSFER TAX: ANALYSIS WITH FORMS ¶ 7.06[3] (2d ed. 2001). At one point, the IRS took the view that the loss of GST exempt status through modification or reformation would cause a gift by the beneficiaries to occur. PLR 9448024; PLR 9421048. A year later, the IRS revised its position to conclude that when a trust loses its GST exempt status, the grantor will be the transferor. PLR 9522032 (IRS amending its ruling in PLR 9421048). It appears then that if the trust loses its GST exempt status and the grantor is treated as the transferor, then you would consider the "normal" rules regarding non exempt trusts, at least as to denying a GST tax benefit that would not be available but for the decanting or modification. For example, distributions made to skip persons who otherwise would not have been entitled to distributions prior to the loss of GST exempt status would be subject to the GST tax after the loss of exempt status.

VII. SPECIAL ISSUES WITH CHARITABLE BENEFICIARIES.

A. Involvement of the Attorney General. In actions involving a trust with charitable beneficiaries, any modification or termination may affect the interest of the charity as beneficiary. In Texas, the charity must be made a party. In addition, Texas law requires the party initiating any proceeding involving a charitable trust to give notice to the Texas Attorney General by sending the Attorney General, by registered or certified mail, a copy of the petition or other instrument initiating the proceeding involving a charitable trust within 30 days of the filing of the petition or other instrument, but no less than 25 days prior to a hearing in the proceeding. TEX. PROP. CODE § 123.003(a). If the Attorney General is not given notice, any judgment is voidable. TEX. PROP. CODE § 123.004. At any time the Attorney General is a proper party and may intervene in a proceeding involving a charitable trust. Additionally, the Attorney General may enter into a compromise, settlement agreement, contract or judgment relating to a proceeding involving a charitable trust. TEX. PROP. CODE § 123.002. In this author's experience, if the charity is represented by qualified independent counsel, the office of the Attorney General rarely gets involved in these matters. However, if they choose to do so, their involvement may slow or complicate any trust modification or termination.

VIII. CONCLUSION.

With the ability to decant possible under common law and as more and more states enact decanting statutes, it is clear that decanting is an area with which advisors should become more familiar. The continuing expansion of the ability to decant makes it clearer that with trusts, irrevocable does not mean that a trust cannot be changed. Therefore, when advising grantors, estate planners may want to discuss whether it is appropriate to give the trustee the ability to decant or to expressly prohibit the trustee from exercising decanting authority. In addition, when advising trustees, there may be situations where it would be important for the trustee to consider decanting as an option and to document any conclusions, keeping in mind that a trustee's fiduciary duties overlay any action by a trustee. As always, the terms of the trust, state statutes or common law, and tax law must be reviewed to determine the limitations to any changes that may be made.

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Back to Table of Contents

RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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This recent developments outline discusses, and provides context to understand the significance of, the most important judicial decisions and administrative rulings and regulations promulgated by the Internal Revenue Service and Treasury Department during the most recent twelve months — and sometimes a little farther back in time if we find the item particularly humorous or outrageous. Most Treasury Regulations, however, are so complex that they cannot be discussed in detail and, anyway, only a devout masochist would read them all the way through; just the basic topic and fundamental principles are highlighted – unless one of us decides to go nuts and spend several pages writing one up. This is the reason that the outline is getting to be as long as it is. Amendments to the Internal Revenue Code generally are not discussed except to the extent that (1) they are of major significance, (2) they have led to administrative rulings and regulations, (3) they have affected previously issued rulings and regulations otherwise covered by the outline, or (4) they provide Dan and Marty the opportunity to mock our elected representatives; again, sometimes at least one of us goes nuts and writes up the most trivial of legislative changes. The outline focuses primarily on topics of broad general interest (to the three of us, at least) – income tax accounting rules, determination of gross income, allowable deductions, treatment of capital gains and losses, corporate and partnership taxation, exempt organizations, and procedure and penalties. It deals summarily with qualified pension and profit sharing plans, and generally does not deal with international taxation or specialized industries, such as banking, insurance, and financial services. Please read this outline at your own risk; we take no responsibility for any misinformation in it, whether occasioned by our advancing ages or our increasing indifference as to whether we get any particular item right. Any mistakes in this outline are Marty's responsibility; any political bias or offensive language is Ira's; and any useful information is Dan's.

I. ACCOUNTING

A. Accounting Methods

1. Judge Haines writes a treatise on defective claims to automatic consent to change an accounting method. Capital One Financial Corp. v. Commissioner, 130 T.C. 147 (5/22/08). Following the enactment in 1997 of § 1272(a)(6)(C)(ii), which provides that credit card late-fee receipts create or increase original issue discount rather than constituting an income item when they accrued under the all events test, the taxpayer claimed to have received the IRS's consent to change its accounting method, pursuant to an automatic consent procedure, by filing Form 3115 with its 1998 tax return. However, the taxpayer did not change its accounting method for 1998 and 1999. In the Tax Court, the taxpayer sought to retroactively change its method for 1998 and 1999. Judge Haines held that § 446(e) prohibited the taxpayer from retroactively changing its treatment of income from credit card late-fees for years 1998 and 1999 from the current-inclusion method to the method under § 1272(a)(6)(C)(iii) that requires late-fee receipts to create or increase original issue discount, even though the OID method was mandatory under the statute, because the taxpayer did not file a Form 3115 to notify the IRS of the change of accounting method with its 1997 return. Because the Form 3115 was not timely filed and did not specifically mention "late fees," automatic consent had not been granted. Judge Haines stated:

> [A] taxpayer forced to change its method of accounting under section 448 must still file a Form 3115 with its return for the year of change. [Reg. § 1.448-1(h)(2)] If the Form 3115 is not filed timely, a taxpayer forced off the cash method must comply with the requirements of [Reg. § 1.446-1(e)(3)] in order to secure the consent of the Commissioner. Reg. § 1.448-1(h)(4). Pursuant to [Reg. § 1.446-1(e)(3)], a taxpayer requesting to change its method of accounting is required to file a Form 3115 during the year in which it intends to make the change.

a. **The taxpayer won the substantive issue, but foot-faulted on seeking a change in method of accounting, so most of the deficiency is upheld. But in future years, it's "ooh la la" for the taxpayer!** Capital One Financial Corp. v. Commissioner, 133 T.C. 136 (9/21/09). This case involved two issues and over $280 million of tax liability – $175 million for one year alone – (apart from penalties). The first issue was the time that third-party credit card issuers are required to recognize credit card income known as interchange. Interchange is the difference between the amount charged on a credit card and the lesser amount remitted to the merchant by the issuing bank. Interchange resembles interest in that it is expressed as a percentage of the amount lent, usually with an additional nominal fee, although it is not time-sensitive and does not vary as interest rates fluctuate. The government argued that interchange income was credit card fee income that was recognized under the all events test at the time the interchange accrued – when the cardholder's credit card purchase was settled through either the Visa or MasterCard system – while the taxpayer argued that the interchange income was original issue discount (OID) that was properly recognized under § 1272(a)(6)(C)(iii), which was added to the Code in 1997, over the anticipated life of the pool of credit card loans to which the interchange related. The Tax Court (Judge Haines) agreed with the taxpayer and held that the interchange income was OID. Interchange is not a fee for any service other than the lending of money. However, because the taxpayer failed to follow proper procedures to change its accounting methods, the OID method was not available for credit card receivables creating or increasing OID in 1998 or 1999. With certain modifications, the method used by the taxpayer to compute the OID income (using a model developed by KPMG) was reasonable.

- A second issue was whether the taxpayer could currently deduct the estimated cost of future redemptions of "miles" it issued to cardholders that could be redeemed for airline tickets, the cost of which would be paid by the taxpayer. The court held that under § 461(h) and Reg. § 1.461-4, those expenses could not be deducted currently, but instead were deductible only to the extent that the amounts were fixed and known under the all events test and for which economic performance had occurred.

b. **And Judge Wilkinson of the Fourth Circuit likes Judge Haines's approach to change of accounting method rules, but avoids writing a treatise.** Capital One Financial Corp. v. Commissioner, 659 F.3d 316 (4th Cir. 10/21/11). The Fourth Circuit, in an opinion by Judge Wilkinson, affirmed both Tax Court decisions. Addressing the OID change of accounting method issue first, the Court of Appeals rejected the taxpayer's argument that because it was changing from an improper method of accounting to a proper method of accounting, it was not required to obtain the IRS's consent to the change of accounting method. It also rejected the taxpayer's argument that an uncodified provision of the 1997 legislation changing the OID rules, which provided that requests to change to the new OID method would be subject to automatic consent, obviated the need to obtain consent. The court reasoned that an uncodified provision cannot override § 446(e), which "requires that taxpayers receive consent before a change in accounting method 'except as otherwise expressly provided in this chapter.'" Finally, the court rejected the taxpayer's arguments that (1) automatic consent changes do not require the filing of a Form 3115, and (2) a Form 3115 filed with the tax return suffices.

- Turning to the issue of whether the taxpayer could currently deduct the estimated cost of future redemptions of "miles" it issued to cardholders, the Court of Appeals affirmed on the grounds that the expenses did not meet the all events test: "When a single mile is awarded for each dollar charged on the card, it remains unknown when the cardholder will earn the 18,000 miles necessary to qualify for an airline ticket. It also remains uncertain when, if ever, the cardholders will redeem their outstanding accumulated miles. Therefore, the amount and timing of Capital One's liabilities with respect to airline tickets for MilesOne cardholders are not fixed until customers redeem their miles." The court rejected the taxpayer's argument that Reg. § 1.451-4, allowing a current deduction for coupons issued in connection with the sale of goods was applicable, holding that credit card lending is not a "sale" of goods.

2. Rev. Proc. 2012-39, 2012- I.R.B. (9/5/12). The IRS announced a change in its policy on automatic accounting method changes in corporate reorganizations. Taxpayers that engage in a tax-free reorganization or liquidation under § 381(a) after 8/31/11 will be allowed to make automatic accounting method changes in the tax year they engage in the transaction. This revenue procedure clarifies and modifies (i) Rev. Proc. 2011-14, 2011-1 C.B. 330; and (ii) Rev. Proc. 97-27, 1997-1 C.B. 680, *as amplified and modified by* Rev. Proc. 2002-19, 2002-1 C.B. 696, *as amplified and clarified by* Rev. Proc. 2002-54, 2002-2 C.B. 432, *as modified by* Rev. Proc. 2007-67, 2007-2 C.B. 1072, *as clarified and modified by* Rev. Proc. 2009-39, 2009-2 C.B. 371, and *as clarified and modified by* Rev. Proc. 2011-14.

B. Inventories

C. Installment Method

D. Year of Inclusion or Deduction

1. **The long arm of § 267(a)(2).** Bosamia v. Commissioner, T.C. Memo. 2010-218 (10/7/10). The Tax Court (Judge Nims) held that § 267(a)(2) applies to the determination of the cost of goods sold when an accrual method taxpayer purchases from a related cash method taxpayer property that will be included in the purchaser's inventory. Thus, because the costs were not paid within two and one-half months after the close of the purchaser's taxable year, the amounts could not be included in COGS. Furthermore, because the adjustment was a change of accounting method, § 481 applied to eliminate from the COGS amounts previously included in costs of goods sold with respect to amounts that remained unpaid in the current year for goods purchased in years beyond the statute of limitations.

a. **Affirmed by the Fifth Circuit.** Bosamia v. Commissioner, 661 F.3d 250 (5th Cir. 10/24/11). In this case presenting a question of first impression, the Fifth Circuit (Judge Garza) held that when the IRS requires a taxpayer to postpone a deduction from gross income under § 267(a)(2), that disallowance constitutes a change in a taxpayer's method of accounting under § 481. An accrual method S corporation purchased music as inventory from a related cash method S corporation during the years 1998-2002, and treated the $877,581 amounts accrued as costs of goods sold when its liability became fixed. However, the purchasing S corporation failed to pay for the music purchases made during those years, which had been closed by the statute of limitations before the IRS audit of the 2004 year. Indeed, the purchasing corporation has not yet to date made those payments, and the selling S corporation has not included those amounts in income. In its audit of the purchasing S corporation for the year 2004, the IRS disallowed $23,351 of erroneously accrued liabilities for music purchased during that year, but not paid for during that year or in the first 2½ months of 2005. The issue was whether the IRS could include the amounts accrued during the closed years 1998-2002 in income under § 481 as resulting from a change of accounting method. An amendment made to § 267(a)(2) in 1984 changed the result of failure to make timely payment from a complete denial of the deduction to a postponement of the deduction until the year of actual payment.

- The court held that the 2004 IRS audit change in the purchasing S corporation's treatment of a "material item," i.e., its cost of goods sold, constituted a change in its method of accounting pursuant to Reg. § 1.446-1(e)(2)(ii)(a). It further held that, even though § 267(a)(2) could preclude any deduction if the payment were never made, that would be the result had the payments been properly accounted for on the cash basis in the years 1998-2002. The court was also unimpressed with the absence of precedent because the IRS's "reasonable" position in its interpretation of the Code and Regulations would have been sustained even had it represented a change of position by the IRS.

2. **The IRS retreats on group liabilities! How far will it go?** Rev. Rul. 2011–29, 2011-49 I.R.B. 824 (11/9/11). This Revenue Ruling holds that an accrual method employer can establish the "fact of the liability" under § 461 for bonuses payable to a group of employees even though the employer does not know the identity of any particular bonus recipient and the amount payable to that recipient until after the end of the taxable year. Rev. Rul. 76–345, 1976-2 C.B. 134, in which the IRS announced that it would not follow *Washington Post Co. v. United States*, 405 F.2d 1279 (Ct. Cl. 1969), was revoked. A change in a taxpayer's treatment of bonuses to conform to this revenue ruling is a change of accounting method that must be made in accordance with §§ 446 and 481, the regulations thereunder, and the applicable administrative procedures. See section 19.01(2) of the APPENDIX of Rev. Proc. 2011-14, 2011-4 I.R.B. 330.

- The logic of this revenue ruling should extend beyond bonuses to other types of "group" liabilities where the group and the aggregate amount owed, but not necessarily the exact identity and payment to each recipient, can be identified.

3. **Simplifying OID! Is that oxymoronic?** Notice 2011–99, 2011-50 I.R.B. 847 (11/28/11). This Notice provides a proposed revenue procedure that will allow taxpayers to use a simplified proportional method of accounting for OID on pools of credit card receivables under § 1272(a)(6). The proportional method allocates to an accrual period an amount of unaccrued OID that is proportional to the amount of pool principal that is paid by cardholders during the period.

4. **Is the IRS reining in the recurring item exception to the "economic performance" rules?** Rev. Rul. 2012–1, 2012-2 I.R.B. 255 (12/13/11). This ruling clarifies the treatment for accrual method taxpayers of liabilities under the recurring item exception to the economic performance requirements under § 461(h)(3) by addressing the application of the "not material" and "better matching" requirements of the recurring item exception to a lease and a related property service contract having one-year terms beginning on July 1 that run over two taxable calendar years, with the entire amount being prepaid, where the taxpayer reasonably expects that it will enter into similar leases and service contracts on a recurring basis in the future. To apply the recurring item exception, the taxpayer must show either that (1) the liability is immaterial or (2) accruing the full liability in the year incurred results in better matching of expenses to related income. Because the taxpayer accrued the liabilities over more than one taxable year for financial statement purposes, the liabilities were material, so the first alternative was not met. Because the taxpayer used the leased property to generate income over the period of lease, accrual of the full amount of the liabilities in a year before economic performance did not result in better matching. Thus, the taxpayer cannot use the recurring item exception. The ruling distinguishes contracts for the provision of services from insurance and warranty contracts and applies the recurring item exception differently. A change in a taxpayer's method of accounting to conform to the revenue ruling is an accounting method change to which §§ 446 and 481 apply. Rev. Proc. 2011-14, 2011-4 I.R.B. 330, is modified and amplified to provide automatic consent.

5. **"One potato, two potato, three potato, four …." To have spudded or not to have spudded, that is the question.** <u>Caltex Oil Venture v. Commissioner</u>, 138 T.C. 18 (1/12/12). The taxpayer, which was on the accrual method, entered into a turnkey contract under which it paid $5,172,666 by cash and note in December 1999 for the drilling of two oil and gas wells. Some site preparation required under the contract occurred in 1999, but drilling was not commenced within ninety days after the end of 1999. The taxpayer deducted the full amount as intangible drilling and development costs (IDC) under § 263(c) in 1999 and the IRS disallowed

the deduction on the ground that the economic performance requirement of § 461(h) was not satisfied. The Tax Court (Judge Gustafson) held that for purposes of the special rules in § 461(i)(2)(A), which provide ninety days leeway after the close of the year for economic performance to occur with respect to drilling oil and gas wells, "drilling of the well commences" when there is "actual penetration" of the ground surface in the act of drilling for purposes of spudding a well. Mere site preparation is insufficient. He emphasized that the title of the provision refers to "spudding," which Webster's Third New International Dictionary 2212 (2002) defines as "to begin to drill (an oil well) by alternately raising and releasing a spudding bit with the drilling rig." Thus, the taxpayer did not qualify under the special rule. Furthermore, the 3-1/2-month rule of Reg. § 1.461-4(d)(6)(ii), which allows a taxpayer to treat a liability as having been economically performed at the time of payment if that taxpayer "reasonably expect[ed] the ... [provider of services] to provide the services ... within 3 ½ months after the date of payment," did not apply "because, in the case of an undifferentiated, non-severable contract, the 3-1/2-month rule contemplates that all of the services called for must be provided within 3-1/2 months of payment." Moreover, even if the 3-1/2-month rule applied to treat some of the services due under the contract as having been economically performed in 1999, the deductions allowed under the 3-1/2-month rule were limited to payments of cash or cash equivalents and did not include payments made by notes. Finally, Judge Gustafson held that a trial was warranted on how much of the IDC was actually incurred in 1999 and could be deducted under the general economic performance rule of § 461(h).

6. **You'll learn more about insurance company taxation than income tax accounting reading this case.** Massachusetts Mutual Life Insurance Co. v. United States, 109 A.F.T.R.2d 2012-837 (Fed. Cl. 1/30/12). The Court of Federal Claims (Judge Horn) held that the taxpayer, an accrual method mutual life insurance company could deduct guaranteed minimum policyholder dividends in the year that the board of directors passed a resolution to pay the dividends during the following year. All events fixing liability had occurred and the obligation to pay out at least a minimum amount established both the fact of liability and that the liability could be determined with reasonable accuracy. Pursuant to § 461(h)(3) and Reg. § 1.461-5 because policyholder dividends were in the nature of return of premium, and they qualified under Reg. § 1.461-4(g)(3) as "rebates or refunds," and thereby satisfied both the matching requirement and the recurring item exceptions to the economic performance rule. Further, the court rejected the government's argument that the economic substance doctrine applied to prevent the taxpayer from accounting for dividends in guarantee years; the taxpayer "did not engage in a typical transaction with an investment followed by a deduction. Instead, as plaintiff notes, plaintiff's payment of policyholder dividends was not designed to generate a tax benefit, rather 'the payment of policyholder dividends is central to Plaintiff's business and that of the mutual life insurance industry as a whole,' and to the benefit of the policyholder."

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

1. **Negotiated allocations characterizing damages received pursuant to a settlement have to be based on fact to be respected.** Healthpoint, Ltd. v. Commissioner, T.C. Memo. 2011-241 (10/3/11). In two different cases Healthpoint sued Ethex for false advertising, unfair competition, and trademark dilution under the Lanham Act and unfair competition, misappropriation, business disparagement under state law, and theft of trade secrets, in connection with Ethex's marketing of a generic drug substitute for one of Healthpoint's trademarked drugs. In one case (Ethex I) the jury awarded Healthpoint (1) actual damages of $5,000,000, (2) disgorgement of Ethex's profits from false advertising and unfair competition of $1,640,000, (3) punitive damages of $3,174,515, and (4) Lanham Act enhanced damages of $6,349,030. The other case (Ethex II) was not tried. Pending appeals, Healthpoint and Ethex settled both cases — Ethex I for $12 million and Ethex II for $4.5 million. Subsequently, Ethex and Healthpoint signed the settlement agreement resolving both cases. After intense negotiations, the damages were allocated under the settlement agreement as follows: (1) Ethex I: (a) damage to goodwill and reputation, $10,450,000; (b) lost profits/disgorgement of profits, $1,350,000; (2)

Ethex II: (a) damage to goodwill and reputation, $4,050,000, (b) lost profits/disgorgement of profits, $450,000. Healthpoint reported $14.5 million in long-term capital gain and $1.8 million in ordinary income. On audit, the IRS determined that all proceeds of the settlement were ordinary income to Healthpoint (and applied a § 6662(a) penalty), but in the Tax Court, the IRS conceded that the Lanham Act enhanced damages of $6,349,030 awarded by the jury for loss of goodwill were taxable as long-term capital gain. The taxpayer argued that the allocation of damages in the settlement agreement should be respected, but the Tax Court (Judge Cohen) held otherwise because the allocation of damages in the settlement agreement was not negotiated on the basis of adverse interests. The court held that "in the light of the circumstances of the settlement and the verdict in Ethex I, the allocations made by the jury should be applied to the settlement of Ethex I for tax purposes." With respect to Ethex II, in which the issues were very similar, the court found that the taxpayer had not met its burden to show that the allocations according to the settlement agreement in Ethex II should be respected. Accordingly, the amounts paid to settle Ethex II were allocated in the same proportions and classifications as those in Ethex I, on the basis of the jury verdict. The court also upheld accuracy related penalties under § 6662 because, while Healthpoint relied on the advice of tax counsel to oversee the settlement agreement, there was no proof that tax counsel offered an opinion on the propriety of the allocations in the settlement agreement or that tax counsel participated in the negotiation of the allocation.

2. **Offshore employee leasing arrangement produces constructive income and fraud penalties.** Browning v. Commissioner, T.C. Memo. 2011-261 (11/3/11). The taxpayer was the principal shareholder and CEO of a Vermont-based manufacturing corporation. The taxpayer leased his services to an Irish corporation, which in turn subleased the taxpayer's services to a U.S. employee leasing company, which then leased the taxpayer's services to the taxpayer's manufacturing company. For tax years 1995-2000 the manufacturing company paid the equivalent of the taxpayer's salary to the U.S. leasing company. The U.S. leasing company paid a portion of the payment to the taxpayer as wages, which the taxpayer reported. After deducting an amount for employment taxes, the U.S. leasing company remitted the remainder of the payment to the Irish corporation, which deposited the payment in a deferred compensation account for the taxpayer. The retirement account was opened in a Bahamas bank by a subsidiary of the Irish corporation. From 1998 the taxpayer obtained a credit card from a Bahamas bank that was supported by an account in the bank that was funded from the retirement account. The credit card was used by the taxpayer for personal expenses. The court (Judge Halpern) found that the taxpayer exercised unrestricted access to the Bahamas retirement account by means of the credit card and easily concluded that the evidence convincingly supported the IRS assertion that the taxpayer was in constructive receipt of income directed through the employee leasing arrangement. For the years after 1998, the court concluded that the taxpayer fraudulently intended to evade tax based on the taxpayer's use of the credit cards and concealment of the existence of the Bahamas bank accounts by answering "no" to the return question asking whether the taxpayer had signature authority over a foreign financial account. Because of the fraud, the statute of limitations remained open for years after 1998. However, the court did not extend its fraud finding to years 1995-1997 because the Bahamas account was not created before 1998. The court also imposed fraud penalties under § 6663 for the years 1998-2000.

3. **A theory that is becoming more attractive to a couple of us is rejected. The one of us who is over 72 is old enough to know better.** West v. Commissioner, T.C. Memo. 2011-272 (11/16/11). The court (Judge Paris) found that the taxpayer failed to meet the burden of proof required to overcome the IRS assertion of a deficiency on the basis of the taxpayer's belief that he did not have to report gross income because he was over the age of 72.

4. **The dentist's income is taxable to the dentist, just like his lawyer's income is taxable to the lawyer.** Walker v. Commissioner, T.C. Memo. 2012-5 (1/9/12). The taxpayer dentist practiced through an LLC, owned 1 percent by the taxpayer and 99 percent by a partnership that included the dentist's children. The arrangement was patterned on entities created by Scott and Darren Cole to avoid income and employment on their law practice and rejected in *Cole v. Commissioner*, 637 F.3d 767 (7th Cir. 2011). The Tax Court (Judge Cohen)

Back to Table of Contents

held that the arrangement represented an anticipatory assignment of income that was taxable to the taxpayer. The only distinction between the taxpayer and the taxpayers in *Cole* was the practice of dentistry versus law, a distinction that did not make a difference.

5. **Assignment of income principles are alive and well, sort of.** Owen v. Commissioner, T.C. Memo. 2012-21 (1/19/12). The taxpayers, John and Laura Owen incorporated a personal services company, J&L Owen, Inc., in which they were the sole shareholders. In 1997, John Owen and two others formed two companies, Family First Insurance Services companies (FFIS) and FFEAP, which sold insurance related and financial products. John was both an officer/employee and an independent contractor salesman. Laura was employed by FFIS as an executive. In 2002, John sold his 50 percent interest in the two companies for $7.5 million, $3.8 million of which was paid in the form of a cashier's check. The taxpayer reported $1.9 million on the sale of FFIS as capital gain and attempted to roll over $1.9 million of gain on the sale of FFEAP into a jewelry business under § 1045 (rollover of an investment of one small business corporation into another small business corporation). In each of January and December 2003 the purchaser paid an additional $1.5 million into the Owen family trust. The taxpayers' accountant mistakenly omitted the second payment from the taxpayers' 2003 return. An employment agreement retained John as President of FFIS and vice-president of FFEAP. Various compensation and incentive payments pursuant to the agreement and amendments signed by John in his role as president of FFIS were made to J&L Owen, Inc. In 2002 J&L Owen, Inc. reported $910,454 of wages to John and $225,000 to Laura on Forms W-2, which wages were deducted by the corporation. The Tax Court (Judge Wherry) held that payments to John for his sales activity in his capacity as an independent contractor for the insurance companies were under the control of J&L Owen, Inc., and were thus income of the corporation. The court indicated that, as an independent contractor, an individual has control over earned income, which includes the right to choose to do business as a corporation. After a factual inquiry into the nature of other payments, the court held that payments to John for consulting and sales promotion activities were made in his capacity as an officer of the insurance companies and therefore not subject to assignment to the personal service corporation. The court rejected the taxpayers' assertion that they over-reported their income for 2002 in the amount reported as compensation from the personal services corporation, stating that the taxpayers failed to meet their burden of showing that they did not receive the amounts reported on W-2s from the personal services corporation. (The IRS also conceded that amounts includable in the taxpayers' income for 2002 under assignment of income principles had been included in the W-2s from the personal services corporation.) The court also noted that while a taxpayer may conduct business in whatever form the taxpayer chooses, the taxpayer must also accept the result.

- With respect to the capital gain the taxpayer attempted to roll over under § 1045, the court held that the jewelry business into which the taxpayer invested proceeds from the sale of FFEAP was not an active trade or business and thus not a qualified small business for § 1045 purposes.

- The court imposed § 6662 accuracy related penalties, holding that the taxpayer did not reasonably rely on the tax advice of the accounting firm that structured the various transactions.

6. **F. Lee Bailey defends himself in the Tax Court, as they say about the client of the (disbarred) lawyer who represents himself . . . .** Bailey v. Commissioner, T.C. Memo. 2012-96 (4/2/12). To facilitate an incarcerated marijuana dealer's forfeiture plan, F. Lee Bailey entered into an unwritten agreement with the Justice Department to deposit $5.9 million of Biochem Pharma stock in his investment account at Credit Suisse Bank that was provided by the client. The purpose of the arrangement was to facilitate repatriation and forfeiture of the client's assets to the U.S. Government as part of a deal to reduce the client's sentence. Mr. Bailey sold some of the stock and borrowed $3 million from Credit Suisse posting the stock as security. Mr. Bailey used the proceeds to make payments on behalf of his client and deposited a portion of the proceeds in personal accounts. When the drug dealer client replaced Mr. Bailey with a different lawyer, the U.S. District Court ordered Mr. Bailey to return the stock to the

court. Unfortunately, he was unable to do so because the bank refused to release the collateral until the loan was paid. As a consequence, Mr. Bailey was held in contempt by the District Court and incarcerated for a period of 44 days. After Mr. Bailey was able to raise capital to repay the Credit Suisse loan and transfer the stock, he was released. Mr. Bailey was reimbursed for out-of-pocket expenses that he paid on behalf of the client but was not paid any fee for his services. In a deficiency notice the IRS asserted that Mr. Bailey had unfettered dominion and control over the stock and therefore recognized as income the full value of the stock at the time it was deposited in his Credit Suisse account. Alternatively, the IRS asserted that if the full value of the stock was not includable in Mr. Bailey's income, at least the value of the stock that he used as collateral for the $3 million loan represented gross income. In a 143 page opinion addressing multiple issues, the Tax Court (Judge Gustafson) held that, based on findings in Mr. Bailey's litigation over the right to retain the stock (*Bailey v. United States*, 54 Fed. Cl. 459 (2002), to which collateral estoppel applied, Mr. Bailey held the Biochem Pharma stock in trust for the U.S. Government. Mr. Bailey was not therefore taxable on the stock's value. However, the court also held that Bailey realized income of approximately $425,000 when he transferred proceeds from sale of some Biochem Pharma stock to his personal accounts in a departure from his fiduciary role. The court also rejected the IRS's assertion that Bailey realized income on the use of $12 million of the appreciated Biochem Pharma stock as collateral for the $3 million loan from Credit Suisse. The IRS argued that Bailey had misappropriated the value of the stock used as collateral for the loan. The court found that Bailey was personally liable for repayment of the Credit Suisse loan and that the loan was a bona fide indebtedness for which there was a consensual recognition of Mr. Bailey's obligation to repay. Thus, the receipt of the loan proceeds was not includible in income.

- The court rejected Bailey's argument that due process barred the government from including in his income $1.6 million in fees that were attached by the government and used to satisfy a portion of the indebtedness to Credit Suisse in order to release the Biochem Pharma stock from the Credit Suisse security, holding that payments made to a third party on behalf of the taxpayer are nonetheless included in income.
- The court rejected Bailey's argument that the burden of proof with regard to substantiation of expenses shifted to the government after he had notified the government that he was disposing of records stored in an aircraft hangar and provided access to those records to auditing agents prior to their destruction. The court observed that taxpayers are required to maintain records, there is no provision that imposes a recordkeeping requirement on the IRS, and the fact that he offered to let the IRS review and copy records before discarding them does not absolve Bailey of the recordkeeping requirement nor shift the burden of proof.
- The court held that Bailey's yacht renovation and rental activity was not an activity engaged in for profit, but that an aircraft renovation activity was a profit seeking activity.
- Finally, Bailey was found liable for negligence penalties.

7. The IRS cuts an illegal drug dealer a break not warranted on the face of the statute. Olive v. Commissioner, 139 T.C. No. 2 (8/2/12). The taxpayer operated a medical marijuana business that sold medical marijuana at retail under the California Compassionate Use Act of 1996. The Tax Court (Judge Kroupa) upheld the IRS's determination that the taxpayer underreported his gross receipts and that § 280E precluded his deduction of business related expenses. The IRS conceded that § 280E did not bar a deduction from gross receipts for costs of goods sold but argued that the taxpayer's ledger entries were inadequate substantiation and that as a factual matter cost of goods sold should be zero. Judge Kroupa sustained the IRS's position that the journal entries were unreliable, but applied *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930) to find, based on expert witness testimony, that the cost of goods sold was approximately 75 percent of the gross receipts and adjusted that amount to account for marijuana that was given away to customers and staff. Judge Kroupa rejected the taxpayer's argument that the expenses should be deductible based on *Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner*, 128 T.C. 173 (2007), in which the Tax Court held that the corporation's care-giving activities for terminally ill patients were a separate trade or business from its medical marijuana delivery and that expenses allocable to the care-giving activity were deductible as ordinary and necessary business expenses. In the instant case, unlike in *Californians Helping to Alleviate Medical Problems*, based on the facts and circumstances there were not two separate and distinct activities. In this case the taxpayer operated a single business of dispensing medical marijuana, with all other services being provided as part of that business.

- Judge Kroupa upheld accuracy-related penalties on the deficiency resulting from unsubstantiated expenses, but not with respect to expenses that were substantiated but disallowed under § 280E, reasoning that the application of § 280E to the medical marijuana industry was decided after the years at issue.

- A straightforward reading of § 280E and the last sentence of § 263A(a)(2) in concert clearly denies the recovery of cost of goods sold for the marijuana in this case. Prior to the enactment of the last sentence of § 263A(a)(2), however, § 280E alone did not deny drug dealers tax-free recovery of the cost of goods sold. *See, e.g., Franklin v. Commissioner*, T.C. Memo. 93-184. In *Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner*, 128 T.C. 173 (2007), the IRS, based on that outdated case law conceded – erroneously in our opinion – that § 280E did not operate to deny as matter of law the cost of goods sold to a taxpayer that purchased and resold marijuana. That mistake was repeated in this case.

B. Deductible Expenses versus Capitalization

1. **Subsidizing Oscar hopefuls.** The Compromise Tax Relief Act of 2010, § 744, extends the election under Code § 181 to expense up to $15 million of qualified film and television production costs incurred in low-income or distressed communities through 2011.

a. **Final regulations come out just in time for the expiration date of the statute.** T.D. 9551, Deduction for Qualified Film and Television Production Costs, 76 F.R. 60721 (9/30/11). Section 181 provides for an election to deduct qualified film or television production costs incurred in productions commenced prior to 1/1/12, as an expense not chargeable to capital account in an amount up to $15 million for each production, or $20 million for production expenses incurred in certain low income or distressed county areas. A production qualifies for the election if at least 75 percent of the total compensation for the production is for services performed in the United States by actors, directors, producers, and production personnel. Final regulations §§ 1.181-1 through -6, replacing temporary and proposed regulations, clarify the owner of production costs, the definition of aggregate production costs for purposes of the election and limitations, and provisions applicable to participations and residuals.

b. **Temporary and proposed regulations update the rules.** REG-146297-09, Deduction for Qualified Film and Television Production Costs Reg. §§ 1.181-0, 1.181-1, 76 F.R. 64879 (10/19/11). The temporary and proposed regulations clarify that the $15 million (or $20 million) limitation under amendments to § 181 applies to limit the aggregate deduction for production costs paid or incurred by all owners of a qualified film or television production for each qualified production, rather than limit the aggregate production costs.

2. **Temporary and proposed regulations provide extensive rules for the acquisition, production, or improvement of tangible personal property.** T.D. 9564, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 76 F.R. 81060 (12/27/11), and REG-168745-03, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 76 F.R. 81128 (12/27/11). The Treasury Department has promulgated temporary regulations, generally effective for tax years beginning on or after 1/1/12, addressing capitalization requirements for expenditures to acquire and improve tangible property. The temporary regulations adopt provisions of regulations proposed in 2008 (REG-168745-03, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 73 F.R. 12838 (3/7/08)), which were in turn based on a 2006 proposal that was substantially modified by the 2008 proposed regulations (REG-168745-03, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 71 F.R. 48590 (8/21/06)). The temporary regulations provide detailed capitalization rules and several

Back to Table of Contents

bright-line standards under §§ 162(a) and 263(a) regarding the acquisition, improvement or repair of tangible real and personal property. The temporary regulations also revise rules under § 168 regarding disposition and maintenance of general asset accounts for MACRS property. In general, the regulations adopt the provisions of the 2008 proposed regulations, but with multiple modifications. Temp. Reg. § 1.263(a)-2T provides rules for amounts paid for the acquisition or production of tangible property, and § 1.263(a)-3T provides rules for amounts paid for the improvement of tangible property. However, these new proposed regulations provide many additional rules. The temporary regulations define material and supplies to treat as deductible (1) the cost of any property with a useful life that does not exceed one year and (2) any item that cost not more than $100. They add a book-conformity de minimis rule, a safe-harbor for routine maintenance, and an optional simplified method for regulated taxpayers. The temporary regulations contain provisions defining a unit of property as a key concept and address capitalization of expenditures that improve or restore a unit of property. The regulations do not provide for a detailed repair allowance rule, but do provide for future I.R.B. guidance regarding industry-specific repair allowance methods.

- *Acquisition and Production Costs*. Temp. Reg. § 1.263(a)-2 provides that a taxpayer must capitalize amounts paid to acquire or produce a unit of real or personal property (as determined under Temp. Reg. § 1.263(a)-3T(d)(2)), including leasehold improvement property, land and land improvements, buildings, machinery and equipment, and furniture and fixtures. Amounts paid to create intangible interests in land are treated as capital expenditures. Amounts paid for work performed on a unit of property prior to the date the property is placed in service must also be capitalized. Temp. Reg. § 1.263(a)-2T(d)(1). Transaction costs to facilitate the acquisition of property are expressly required to be capitalized, Temp. Reg. § 1.263(a)-2T(f), but facilitative expenditures do not include employee compensation or overhead unless the taxpayer elects to capitalize such expenditures. Expenditures to defend or protect title must be capitalized. Temp. Reg. § 1.263(a)-2T(e).
- *Selling Expenses.* Temp. Reg. § 1.263(a)-1T(d) provides for the capitalization of selling expenses as an offset against sales proceeds (except in the case of dealers).
- *Materials and Supplies.* As under the prior rules, Temp. Reg. § 1.162-3T allows a deduction for incidental material and supplies in the year an expenditure is made. Materials and supplies are incidental when they are carried on hand and for which no record of consumption is maintained or when not carried in inventory. A deduction for non-incidental materials and supplies is allowed *in the year the property is consumed*. Materials and supplies include tangible property that is (1) a component acquired to repair or improve a unit of tangible property that is not acquired as part of a unit of property, (2) fuel, lubricants, water and similar items that are reasonably expected to be consumed within 12 months, and (3) tangible property that is a unit of property with (a) an economic useful life to the taxpayer of not more than 12-months, or (b) that costs not more than $100 (an embedded de minimis rule). Temp. Reg. § 1.162-3T(c). Taxpayers may elect to capitalize the cost of each item of material or supply. Items used in the production of other property remain subject to the uniform capitalization rules of § 263A. Temp. Reg. § 1.263A-1T(b). On sale or disposition, materials and supplies are not treated as capital assets. Temp. Reg. § 1.162-3T(g).
- *Rotable Spare Parts.* Rotable spare parts are components treated as materials and supplies that are installed in a unit of property, are removable from the unit of property, and are generally repaired and improved for installation in a unit of property or stored for later use. The cost of rotable spare parts is deductible in the year of the disposition of the part. Temp. Reg. § 1.162-3T(a)(3). Temp. Reg. § 1.162-3T(e) provides an elective optional method of accounting for the treatment of rotable and temporary spare parts under which (1) the taxpayer deducts the amount paid for the part in the year the part is first installed on a unit of property, (2) in each year the part is removed from a unit of property the taxpayer includes the fair market value of the part in gross income, (3) includes in the basis of the part the value taken into income plus amounts paid to remove the part, (4) includes in the basis of the part any amounts expended to maintain the part, (5) then deducts the basis and any cost incurred to reinstall the part in a unit of

Back to Table of Contents

property, and finally (6) deducts the basis of the part on final disposition.

- *Financial Accounting De Minimis Rules.* Temp. Reg. § 1.263(a)-2(g) allows a taxpayer to deduct expenditures to acquire or produce property (other than property produced for resale) if the taxpayer expenses the cost on a certified audited financial statement (including audited financial statements prepared by an independent CPA and used for non-tax purposes and certain financial statements filed with regulatory agencies) pursuant to a written accounting procedure adopted by the taxpayer that treats as expenses amounts paid for property costing less than a specified dollar amount, as long as the amounts deducted under the de minims rule do not exceed the lesser of 0.1 percent of the taxpayer's gross receipts or 2 percent of the taxpayer's total depreciation and amortization expense reflected in its financial statement. (The temporary regulations remove a provision in the 2008 proposed regulations that the aggregate amount deducted do not materially distort the taxpayer's income for purposes of § 446.) Property subject to the de minimis rule cannot be treated on sale or other disposition as a capital or § 1231 asset. A taxpayer may elect to apply the de minimis rule of Temp. Reg. § 1.263(a)-2T(g) to material and supplies, including rotable spare parts, which are then not treated as materials or supplies under Temp. Reg. § 1.162-3T. Temp. Reg. § 1.162-3T(f).

- *Unit of Property.* Temp. Reg. § 1.263(a)-3T(e). The unit of property concept is central to the proposed regulations' requirement that improvements to a unit of property must be capitalized.

- Temp. Reg. § 1.263(a)-3T(e)(2) provides that a building and its structural components (as defined in Reg. § 1.48-1(e)(2)) are treated as a unit of property.[1] However, the improvement rules must be separately applied to components of a building including heating, ventilation and air conditioning systems, plumbing systems, electrical systems, elevators and escalators, fire protection and security systems, gas distributions systems, and other systems identified in published guidance. Condominium units and cooperative units are each treated for the owner as a unit of property. Similarly, a leasehold interest in a portion of a building is treated as a unit of property.

- Temp. Reg. § 1.263(a)-3T(e)(2) defines a unit of property for property other than buildings as including all the components that are functionally interdependent. Components of property are functionally interdependent if the placing in service of one component is dependent on the placing in service of the other component. However, a component that is recorded on the taxpayer's books as having a different economic useful life or which is in a different class of property for MACRS depreciation would be treated as separate unit of property. Thus, for example, all of the component parts of a railroad locomotive constitute a single unit of property, as does a truck trailer and its tires (unless the taxpayer the taxpayer's financial statements treat them as separate property). A special rule applies to "plant property," which is a functionally integrated collection of equipment and machinery used to perform an industrial process; each component (or group of components) that performs a discrete and major function or operation within the functionally interdependent machinery or equipment constitutes a separate unit of property. Determinations of a unit of property with respect to network assets are based on the taxpayer's facts and circumstances unless otherwise provided in published guidance. Network assets include property such as railroad tracks, oil, gas, water and sewage pipelines, power transmission lines, and cable and telephone lines that are owned or leased by taxpayers in those industries.

- *Capitalization of Improvements.* Expenditures to improve a unit of property must be capitalized. Temp. Reg. § 1.263(a)-3T(d). Amounts expended for repairs

[1] Under Reg. § 1.48-1(e)(2), structural components of a building include such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings therefor such as paneling or tiling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts; plumbing and plumbing fixtures, such as sinks and bathtubs; electric wiring and lighting fixtures; chimneys; stairs, escalators, and elevators, including all components thereof; sprinkler systems; fire escapes; and other components relating to the operation or maintenance of a building.

Back to Table of Contents

and maintenance of tangible property are deductible if they are not required to be capitalized under Temp. Reg. § 1.263(a)-3T. Temp. Reg. § 1.162-4T. Expenditures that improve tangible property and that are required to be capitalized include expenditures that:

º Result in a "betterment" to a unit of property (replacing the term "material increase in value" used in the original proposal);

º Restore a unit of property; or

º Adapt the unit of property to a new or different use.

Temp. Reg. § 1.263(a)-3T(f) provides special rules requiring a lessee to capitalize expenditures for improvements to a unit of leased property. A lessor is required to capitalize the cost of improvements to leased property paid directly or through a construction allowance to the lessee. (The preamble to the regulations states that the recovery period for an improvement or addition to the "underlying property" begins on the placed-in-service date of the improvement or addition. See § 168(i)(6); Temp. Reg. § 1.168(i)-8T(c)(4)(ii)(E).)

- *Betterment.* Temp. Reg. § 1.263(a)-3T(h). An expenditure results in a betterment of a unit of property if it (1) ameliorates a material condition or defect that existed prior to acquisition of the property or arose during production of the property, (2) results in a material addition to a unit of property, or (3) results in a material increase in capacity. Determination of whether an expenditure results in a betterment is factual and requires a comparison of the condition of the property immediately prior to the circumstance necessitating the expenditure (or the condition of property the last time the taxpayer corrected for normal wear and tear) with the condition of the property after the expenditure. An expenditure that results in a betterment of a component of a building is treated as a betterment to the unit of property consisting of the building and its structural components.

- *Restoration.* Temp. Reg. § 1.263(a)-3T(i). An expenditure is capitalized as a restoration if it (1) replaces a component for which the taxpayer has deducted a loss, (2) replaces a component the adjusted basis of which has been accounted for in realizing gain or loss on a sale or exchange of the component, (3) repairs damage for which the taxpayer has deducted a casualty loss under § 165, (4) returns the property to its ordinary operating condition after the property as fallen into a state of disrepair and is no longer functional, (5) results in rebuilding the property to a like-new condition at the end of its class life under the § 168(g) alternative depreciation system, or (6) is for the replacement of a major component or structural part of the unit of property. Whether there is a replacement of a major component or structural part is determined under the facts and circumstances and includes replacement of a major component or structural part that comprises a large portion of the physical structure of the unit of property or that performs a discrete and critical function in the operation of the nit of property. (The 50 percent of replacement cost test of the proposed regulations was eliminated.) Again, the restoration of a component of a building is treated as a restoration of the unit of property consisting of the building and its structural components.

- *New Use.* Temp. Reg. § 1.263(a)-3T(j). A unit of property is treated as adapted to a new or different use if the adaptation is not consistent with the taxpayer's "intended ordinary use of the unit of property at the time originally placed in service by the taxpayer." An expenditure to adapt a component of a building to a new use must be capitalized as an expenditure to adapt the unit of property consisting of the building and its structural components to a new use.

- *Rehabilitation doctrine is no more.* Temp. Reg. § 1.263(a)-3T(f)(3) eliminates the judicially created rehabilitation doctrine by providing that, "[I]ndirect costs that do not directly benefit or are not incurred by reason of an improvement are not required to be capitalized under section 263(a), regardless of whether they are made at the same time as an improvement." But the regulations provide that if otherwise deductible repairs benefit or are incurred by reason of an improvement, the cost of the repairs must be capitalized under § 263A.

- *Routine Maintenance Safe Harbor.* Temp. Reg. § 1.263(a)-3T(g) provides a safe harbor from the capitalization requirement for "the recurring activities that a taxpayer expects to perform as a result of the taxpayer's use of the unit of property to keep the unit of property in its ordinarily efficient operating condition." The safe harbor applies to activities that the taxpayer reasonably expects to perform more than once during the class life of the property, as determined under the MACRS alternative depreciation schedule of § 168(g). Routine maintenance includes maintenance with respect to and the use of rotable spare parts. Routine maintenance excludes activities that follow a basis recovery event similar to the items that are described as restorations.

- *Repairs.* Temp. Reg. § 1.162-4T allows as a deductible repair expense any costs that are not required to be capitalized under Temp. Reg. § 1.263(a)-3T.
- *Repair Allowance.* The regulations do not provide for a repair allowance, but Temp. Reg. § 1.263(a)-3T(*l*) permits taxpayers to use a repair allowance method that is authorized by published guidance in the Federal Register or the Internal Revenue Bulletin, suggesting that such rules will be forthcoming.
- *Examples.* The regulations are full of examples that seem to cover most of the litigated cases and rulings addressing capitalization versus repair. The examples are necessary to understand the substantive provisions, which, although intended to provide clarity, are not so clearly applied.

a. **IRS specifies the procedures for adopting new accounting methods under the Temporary Regulations.** Rev. Proc. 2012-19, 2012-14 I.R.B. 689 (3/7/12), *modifying* Rev. Proc. 2011-14, 2011-1 C.B. 330. The IRS has provided lengthy and detailed rules regarding automatic changes in methods of accounting under Temp Reg. §§ 1.162-3T & 4T (materials and supplies), 1.263 (a)-1T (capital expenditures in general), 1.263 (a)-2T (transaction costs), and 1.263 (a)-3T (improvements), all added by T.D. 9564, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 76 F.R. 81060 (12/27/11). These changes are for taxable years beginning on or after January 1, 2012.

b. **LB&I provides guidance under Rev. Proc. 2012-19.** LB&I-4-0312-004 (3/15/12). This directive to the field applies to taxpayers who adopted a method of accounting relating to the conversion of capitalized assets to repair expense under § 263(a).

3. **Just because state law requires you to make the payment doesn't mean it's an ordinary and necessary business expense.** Zweifel v. Commissioner, T.C. Memo. 2012-93 (3/28/12). Citing *Sebring v. Commissioner*, 93 T.C. 220, 227 (1989); *Firetag v. Commissioner*, T.C. Memo. 1999-355, *aff'd without published opinion*, 232 F.3d. 887 (4th Cir. 2000); and *Rankin v. Commissioner*, T.C. Memo. 1996-350, *aff'd*, 138 F.3d 1286 (9th Cir. 1998), the Tax Court (Judge Paris) held that a "buildup fund account" into which a bail bondsman is required under state law to make deposits to reimburse insurers for losses on bail bonds underwritten by the bail bondsman are not deductible in the year of the contribution to the account, because the expense for which the account was created has not yet arisen.

- As a condition of doing business, taxpayer bail bond agent was required by state law to maintain a "build-up fund" of 1 percent of bonds executed as an agent of National Surety Services (the underwriter) for the purpose of establishing an indemnity to protect the insuring company from loss through the posting of bonds by the agent. The taxpayer had legal title to the funds, was taxable on interest, and was entitled to return of the funds on termination of the contract with the insurer and discharge of remaining open bonds. Judge Paris rejected the taxpayer's argument that the payments were in the nature of insurance premiums paid to financially protect the taxpayer. The court indicated that the payments are specific payments tied to an individual bond and are not a general contract to protect against unforeseen losses. The court held that the payments are deductible when amounts are paid out of the build-up fund to the insurer.
- The court sustained penalties for failure to timely file and indicated with respect to negligence penalties that, although the taxpayer presented "well thought-out arguments" to distinguish prior case law with respect to the claimed deductions, the taxpayer's failure to timely file indicates that the taxpayer did not act in good faith or with reasonable cause.

4. **Avoided interest attributable to associated property taken out of service requires capitalization under *Chevron*-tested regulations that barely survive.** Dominion Resources, Inc. v. United States, 97 Fed. Cl. 239 (2/25/11). The taxpayer, an electric utility, removed boilers from service to replace burners. Reg. § 1.263A-11(e)(1)(ii)(B) requires

that the capitalized cost of improvements under § 263A include both direct expenditures and the capitalized cost of interest (under the avoided cost rules) attributable to the basis of property temporarily removed from service in order to complete the improvements. The court (Judge Lettow) rejected the taxpayer's arguments that (1) the associated property rule of Reg. § 1.263A-11(e)(1(ii)(B) is invalid as inconsistent with § 263A, and (2) it was adopted in contravention of the requirements of the Administrative Procedure Act. Under the test of *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), the taxpayer argued that the regulation was inconsistent with § 263A(f)(2)(A)(ii), which provides that for purposes of determining production period interest "with respect to any property . . . interest on any . . . indebtedness [not directly attributable to production expenditures] shall be assigned to such property to the extent that the taxpayer's interest costs could have been reduced if production expenditures . . . had not been incurred." The taxpayer asserted that "property" for this purpose under the statutory language can include only the improvement itself, which is separately depreciable, and cannot, therefore be expanded to include associated property as provided in the regulation. The taxpayer also argued that the production costs were incurred with respect to the replacement burners, and not with respect to the boilers themselves. While the court was not completely happy with the IRS's argument that the property can be separated for depreciation purposes while considered as a unit for purposes of the interest allocation, the court concluded that the statute was sufficiently ambiguous under the first prong of the *Chevron* test, that the regulation could be tested under the second prong of *Chevron*, which asks whether the regulation is a permissible construction of the statute. Here the court indicated that, "It is stretching the statute quite far to say that the associated-property rule 'is a reasonable interpretation' of the enacted text [of section 263A]." The court added that the IRS's rationales "are not very satisfying." The court then concluded, however, that "it is not this court's province to be making such policy choices. In this very close case, the court cannot say that Treasury overstepped the latitude granted by the statute to adopt regulations prescribing the calculation of interest to be capitalized in connection with an improvement to existing property used by the taxpayer to produce income" and held that the regulation therefore survived the taxpayer's challenge. With respect to the taxpayer's challenge under the Administrative Procedure Act, the court again found that "it is a stretch to conclude that Treasury 'cogently explain[ed] why it has exercised its discretion in a given manner,'" but added that "[t]he 'path' that Treasury was taking in the rulemaking proceedings can be 'discerned,' albeit somewhat murkily" and upheld the regulation. Finally, the court rejected retroactive application of a de minimis rule of Reg. § 1.263A-11(e)(2) to the taxpayer, and denied the IRS's counterclaim for capitalization of additional interest.

- No pretzel in existence has as many twists and bends as does this opinion.

a. But the regulation does not survive *Chevron* analysis on appeal. Dominion Resources, Inc. v. United States, 109 A.F.T.R.2d 2012-2316 (Fed. Cir. 5/31/12). The Court of Appeals for the Federal Circuit (in an opinion by Judge Rader) reversed the Court of Federal Claims decision upholding Reg. § 1.263A-11(e)(1)(ii)(B), which requires that the capitalized cost of improvements under § 263A include both direct expenditures and the capitalized cost of interest (under the avoided cost rules) attributable to the basis of property temporarily removed from service in order to complete the improvements, by invalidating the regulation under step two of the *Chevron* analysis. The majority of the Federal Circuit panel held that "the regulation is unreasonable in defining 'production expenditures' to include the adjusted basis of the entire unit," because "[t]he regulation directly contradicts the avoided-cost rule that Congress intended the statute to implement." The opinion illustrated the problem with the following example.

> For example, let's say an owner purchased real property for $100,000 by a loan with a 3% interest rate. A few years later, she made an improvement that cost $5,000. If she had used that $5,000 toward the debt instead of the improvement, she would have avoided accruing $150 in interest ($5,000 multiplied by 3%). The avoided-cost rule requires her to capitalize that $150 in interest. The Treasury

Back to Table of Contents

regulation, however, requires her to capitalize $3,150 in interest ($100,000 + $5,000 then multiplied by 3%). That result makes no sense, because there is no way that she could have avoided accruing $3,150 in interest by not making the improvement, as she did not expend or incur an amount equal to $105,000 when making the improvement.

- The court went on to point out that "[t]he only way that an amount equal to the adjusted basis could potentially satisfy the avoided-cost method is by assuming that the property owner would have sold the unit and used the sale proceeds to pay down the debt." Based on this analysis the Court of Appeals concluded that the Court of Federal Claims erred by concluding that the regulation reflected a "policy choice" by the agency and was thus permissible.
- The majority also invalidated the regulation, as did the concurring opinion of Judge Clevenger, on the basis that it violated the requirement imposed by the Supreme Court in *Motor Vehicles Mfrs. Ass'n of the United States, Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983), that the agency must provide a reasoned explanation for adopting a regulation. "*State Farm* requires that the Treasury 'articulate a satisfactory explanation for its action, including a rational connection between the facts found and the choice made.'" Neither the preamble to the proposed regulations nor the preamble to the final regulations (nor Notice 88-99, 1988-2 C.B. 422) provided any rationale for adopting the rule in the regulations; there was "no explanation for the way that use of an adjusted basis implements the avoided-cost rule."

5. Proposed regulations restrict negative numbers in allocating indirect costs under the complicated "simplified methods rules." REG-126770-06, Allocation of Costs under the Simplified Methods, 77 F.R. 54482 (9/5/12). Section 263A requires capitalization of all direct and indirect costs into goods produced during the year and inventory, so-called § 471 costs that must be included in inventory. Section 263A costs may be allocated on a facts and circumstances basis, or the taxpayer may use the simplified resale or simplified production methods provided in Reg. §§ 1.263A-2(b) and 1.263A-3(d) to allocate costs to eligible property produced or held for resale in lieu of a facts-and-circumstances allocation method. Under the simplified method a pool of additional capitalized § 263A costs (indirect costs not otherwise includible in inventory under the taxpayer's method of accounting) may be allocated among ending inventory and costs of goods sold based on an "absorption ratio" of such costs to the taxpayer's total § 471 inventory costs. In some circumstances the simplified method will produce negative amounts that cause distortions in inventory accounting, generally when a taxpayer capitalized a cost as an inventory cost that is greater than the amount required to be capitalized for tax purposes. Proposed Reg. § 1.263A-2(b) would, with certain exceptions, prevent taxpayers from using negative amounts in determining additional § 263A costs. Producers with average annual gross receipts of less than $10,000,000 would be allowed to continue to include negative amounts in additional § 263A costs. Retailers who use the simplified resale method would be permitted to remove inventory costs that are not required to be capitalized for tax purposes from ending inventory by treating them as negative additional § 263A costs.

- The proposed regulations include a modified simplified production method that would allow producers to separately determine the allocation of preproduction related additional § 263A costs using a preproduction cost absorption ratio applied to capitalized inventory costs for raw materials.
- As a sop for simplification, the proposed regulations would redefine a taxpayer's "additional § 263A costs" for purposes of the simplified methods as costs, other than interest, that a taxpayer capitalized to its inventory in its financial statements. The definition would provide, however, that a taxpayer must include all direct costs in its § 471 costs regardless of the taxpayer's treatment of the costs in its financial statements.

C. Reasonable Compensation

1. Non-limit limitations on excessive compensation to corporate officers. REG-137125-08, Certain Employee Remuneration in Excess of $1,000,000 Under Internal Revenue Code Section 162(m), 76 F.R. 37034 (6/24/11). Section 162(m) limits deduction for compensation to top corporate officers of publicly traded corporations to $1 million with an exception to performance based compensation attributable to stock options and stock appreciation rights. Proposed regulation § 1.162-27(e)(2)(iv) would require that performance based compensation plans designate the maximum number of shares with respect to which options or rights may be granted to an individual employee during a specified period. The preamble to the proposed regulations indicates that the IRS rejects assertions that specifying a limit is not necessary because such plans require shareholder approval as contrary to its interpretation of legislative history as requiring an objective formula for determining the maximum amount of compensation an employee could receive if the employee's performance goal is met.

a. Performance based compensation is based in part on performance. Rev. Rul. 2012-19, 2012-28 I.R.B. 16 (6/25/12). The limitation of § 162(m) on deduction of employee compensation to an applicable employee by a publically held company to $1,000,000 does not apply to performance based compensation. The IRS rules that a corporate plan to pay dividends and dividend equivalents on restricted stock granted to an employee that vests on meeting performance goals is performance based compensation. However, dividends and dividend equivalents payable on restricted stock regardless of whether the employee meets performance goals does not qualify as performance based compensation. The ruling cites Reg. § 1.162-27(e)(2), which provides that performance based compensation must be paid solely on account of pre-established performance goals based on an objective standard, on a grant-by-grant basis.

2. Every time a reasonable compensation case is appealable to the Seventh Circuit, it seems that whoever the judge is, after doing the *Exacto* bit to satisfy Judge Posner, he or she adds something like, "and in any event it wasn't deductible because it wasn't intended to be compensation." Mulcahy, Pauritsch, Salvador & Co. v. Commissioner, T.C. Memo. 2011-74 (3/31/11). The taxpayer, an accounting and consulting firm operating as a C corporation, made payments to three related entities owned by the three named principals of the corporation that essentially resulted in zeroing out the taxpayer's income for the year. The related entities performed no services for the taxpayer, and at trial the taxpayer claimed that the payments were deductible as compensation to the named principals, who did perform services for the taxpayer. The court (Judge Morrison) held that even if the payments were viewed as compensation to the named principals, the payments were not deductible. Applying the "hypothetical independent investor" test of *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 (7th Cir. 1999), because the case was appealable to the Seventh Circuit, Judge Morrison found that the rate of return on the firm's equity was "too low to create a presumption that the amounts claimed as 'consulting fees' were reasonable compensation for the [principals'] services." Because the taxpayer presented no other relevant evidence that the payments were reasonable in amount, the deduction was disallowed. Judge Morrison added that besides being reasonable in amount, to be deductible the payment must be intended to be compensation, and the payments in question were not intended to be compensation.

> [The firm] intended for the payments to the related entities to distribute profits, not to compensate for services. ... Salvador chose the amount to pay each year so that the payments distributed all (or nearly all) accumulated profit for the year. He did this for tax planning purposes. Each [principal's] percentage of the payments to the related entities was tied to hours worked, but the firm's intent in making the payments was to eliminate all taxable income. The firm did not intend to compensate for services.

- Accuracy related penalties were upheld, with Judge Morrison taking special note of the fact that the taxpayer was an accounting firm.

a. And Judge Posner agrees adding "[t]hat an *accounting* firm should so screw up its taxes is the most remarkable feature of the case." Mulcahy, Pauritsch, Salvador & Co. v. Commissioner, 680 F.3d 867 (7th Cir. 5/17/12). The Seventh Circuit (Judge Posner) affirmed the Tax Court, holding that the consulting fee payments to the three related entities owned by the three named principals of the C corporation, did not constitute deductible compensation but, instead, constituted a return on invested capital, i.e., dividends. This is because the taxpayer corporation was not "a pane of glass" between the billings of a typical small professional services firm and the salaries of its professionals where the amount of capital invested is negligible. Here, the taxpayer corporation had 40 employees in multiple branches, so the amount of invested capital was relatively large, and the consulting fees constituted a return on that invested capital. Judge Posner noted that treating the consulting fees as salary expenses reduced the firms return to equity to zero even though the firm was "doing fine" flunks the independent-investor test.

- During the course of the opinion, Judge Posner managed to chide taxpayer's lawyers for "appear[ing] not to understand the difference between compensation for services and compensation for capital." He also chided taxpayer's expert witness for using "firm income per partner" of comparable accounting firms without "divid[ing] firm income per partner into salary and dividend components," which rendered his testimony "irrelevant."

- Judge Posner noted his "puzzlement" that the firm did not organize as a pass-through entity, but noted that it had to accept the consequences of its entity choice, "that in this case include[d] a large tax deficiency and a hefty penalty."

- See *Charles McCandless Tile Service v. United States*, 191 Ct. Cl. 108, 422 F.2d 1336 (Ct. Cl. 1970). It held that 15 percent of profits (before stockholders' salaries) should be considered as a dividend, and should reduce the deduction for salaries paid accordingly. That case aroused a great deal of interest when it first came out, and led to all sorts of closely held corporations paying out dividends of about $1,000 per year to establish a history of paying dividends.

D. Miscellaneous Deductions

1. Standard mileage rate rules published in a revenue procedure while the amounts will be disclosed in a separate notice. Rev. Proc. 2010-51, 2010-51 I.R.B. 883 (12/3/10). The IRS indicated that beginning in 2011 it will publish mileage rates in a separate annual notice. The revenue procedure indicated that a taxpayer may use the business standard mileage rate to substantiate expenses for business use of an automobile in lieu of fixed and variable costs. Parking fees and tolls are deductible as separate items. The basis of an automobile used for business is reduced by a per-mile amount published in the annual notice. Separate rates are provided both for charitable use of an automobile and medical and moving use of an automobile. The revenue procedure also provides details for treating as substantiated a fixed and variable rate allowance for expenses incurred by an employee in driving an automobile owned or leased by the employee in performing services for the employer.

a. Standard mileage rates for 2012. Notice 2012-1, 2012-2 I.R.B. 260 (12/9/11). The standard mileage rate for rolling the tires after 1/1/12 remains at 55.5 cents (23 cents representing depreciation). The mileage rate for charitable service is 14 cents, and for medical care or moving expenses the rate is slightly down to 23 cents. The maximum standard automobile cost for computing the allowance under a fixed and variable rate (FAVR) plan is $28,000 for automobiles and $29,300 for trucks and vans.

b. The IRS announces per diem rates for travel away from home. Notice 2012-63, 2012 I.R.B. ___ (9/26/12). Per diem reimbursement rates in lieu of substantiated expenses under Rev. Proc. 2011-47, 2011-42 I.R.B. 520, effective for travel after 10/1/12, are unchanged from 2011. One revision, however, removes transportation expenses between points, lodging and meals, and mailing expense for travel vouchers from incidental expenses, so that these items may be separately reimbursed for travelers using the per diem method. Per diem rates are as follows:

- The special meals and incidental rates for the transportation industry are $59 within CONUS and $64 OCONUS.

- Incidental expense deduction for any location is $5 per day (the IRS believes in cheap tippers).

Back to Table of Contents

- Rates for travel within CONUS are $242 per day for high cost localities (listed in the notice) and $163 for all others. The portion allowed for meals is $65 in a high-cost locality and $52 for others.

2. Researching tax dodges doesn't qualify for the R&D credit. The Heritage Organization, LLC v. Commissioner, T.C. Memo. 2011-246 (10/19/11). Heritage was an LLC owned by four members consisting of Holdings, Inc. and three limited partnerships. Heritage was operated by Gary Kornman, the sole owner of Holdings, which in turn was a five percent member of Heritage, and William Ralph Canada. Heritage was engaged in producing and managing life insurance for high net worth individuals and became involved in tax and estate planning for clients. Heritage maintained a subsidiary responsible for identifying and researching potential clients and referring them to Kornman and Canada who worked to complete life insurance transactions. Heritage's research subsidiary also conducted legal and tax research regarding corporate and trust structures to minimize taxes, including Son of Boss transactions. Kornman controlled eleven dormant corporations, each of which was transferred to a trust created by Kornman and Canada. Heritage lent $1 million to each corporation which was used by the corporation to engage in a short sale of U.S. Treasury notes through individual brokerage accounts that were in turn transferred to a trading partnership. In January 2000 each corporation closed its short sales at a loss and transferred funds back to Heritage in partial payment of the loans, leaving an outstanding balance of $275,000 in each corporation. In December 2000, the Heritage secretary, who also was an officer in each corporation, sent checks to herself from each corporation in the amount of $550,000. The checks were ultimately rejected and payment was effected through a wire transfer in January 2001. While checks sent by a cash method taxpayer are generally deductible in the year the checks are distributed, the court (Judge Paris) ruled that since the checks were ultimately settled by the subsequent wire transfer in 2001, the expenditures were attributable to Heritage's 2001 tax year. In addition, the court rejected the taxpayer's claim that the $6,050,000 represented by the payments to the eleven corporations was deductible as a § 174 research and experimental expense based on the taxpayer's assertion that the expenses were incurred to "develop" a set of shelf corporations with embedded losses. The court indicated that the expenditure was not for research in the experimental or laboratory sense and was not incurred to eliminate uncertainty concerning the development of a product. The court also rejected the taxpayer's argument that the expenditure was deductible under § 162 as an ordinary and necessary business expense. The court concluded that the payoff to the eleven corporations was to meet the losses incurred by the corporations on their short sales and that Heritage had not shown that it was obligated to repay the corporations for losses from investment activity. The court further indicated that under the TEFRA rules the disallowed deduction was a partnership item thereby increasing the distributive share of each partner's partnership income. Finally, the court sustained negligence penalties under § 6662.

3. Apparently the Tax Court is unaware that under No Child Left Behind teachers' pay is determined with reference to their students' performance. Farias v. Commissioner, T.C. Memo. 2011-248 (10/24/11). The taxpayer was an elementary school teacher whose classes included health, nutrition, and fitness. The school provided teachers with basic classroom supplies, and purchases of anything beyond basic supplies were left to the teacher's discretion. Teachers were not reimbursed for any items purchased for the classroom. The taxpayer claimed deductions for the cost of "candy and sugar" provided to students as incentives, although her documentation was not perfect. She also testified that she purchased a U.S. savings bond that was presented to a student in recognition of community service provided to the school. Judge Cohen upheld the disallowance of all of the claimed expenses. "There is no evidence that the school required the purchase of the candy or the savings bond for petitioner's students. These expenses were not necessary to petitioner's job; and no matter how well intentioned, gifts to students are not deductible as business expenses."

4. Unsubstantiated expenses are not allowed as deductions, but the business had to have some expenses even after walking away. Bell v. Commissioner, T.C. Memo. 2011-296 (12/22/11). In a return for his 1996 tax year, filed ten years late, the pro se taxpayer claimed expenses from his landscaping business. The IRS assessed a deficiency for understated income and disallowed the expenses. The taxpayer asserted that he lost all of his records because, "It has been all destroyed due to the [criminal] case that I was dealing with in '96. I had a choice of walking away or doing jail time, and I chose to walk away." The court (Judge Wherry), following the rule of *Cohan v. Commissioner*, 39 F.2d 540, 543-544 (2d Cir. 1930), indicated that "it is inconceivable that he did not pay some expenses operating the landscaping business. We believe petitioner had to have paid expenses such as for the rental of machinery, for repairs and maintenance of his equipment, and incidental expenses such as gas for lawnmowers and related equipment." The court thus allowed $3,283 of the approximately $36,000 claimed by the taxpayer. The court also rejected the taxpayer's assertion the wage income shown on his 1996 return, prepared by Beverly A. Arrington, was fabricated by her, and imposed penalties under § 6651(a)(1) for failure to file a timely return and § 6662(a) accuracy-related penalties.

5. A partner's unreimbursed reimbursable expenses incurred on behalf of the partnership are not deductible on his own return. McLauchlan v. Commissioner, T.C. Memo. 2011-289 (12/19/11). The taxpayer was a partner in a law firm and he paid various expenses, such as advertising, home office, automobile, travel, meals, entertainment, cell phone, professional organizations, continuing legal education, state bar membership, supplies, interest, banking fees and legal support services in connection with his law practice. The partnership reimbursed him for over $60,000 of the expenses in each year in question, but he claimed more than $100,000 of additional expense on Schedule C in each year. The Tax Court (Judge Kroupa) articulated the principal issue as whether a partner can deduct unreimbursed expenses incurred in furtherance of the partnership's business. She then articulated the relevant legal principle as prohibiting a partner from deducting on his own return expenses of the partnership, even if the expenses were incurred by the partner in furtherance of partnership business, unless there is an agreement among partners, or a routine practice equal to an agreement, that requires a partner to use his or her own funds to pay a partnership expense, citing *Cropland Chem. Corp. v. Commissioner*, 75 T.C. 288, 295 (1980), *aff'd without published opinion*, 665 F.2d 1050 (7th Cir. 1981). In the instant case, the partnership agreement required petitioner to pay "indirect partnership expenses" that were unreimbursable, but there was no routine practice that required petitioner to pay any other partnership expenses. Thus, expenses at issue were deductible only if they were unreimbursable indirect partnership expenses that were actually incurred. Turning to the facts, Judge Kroupa found that all of the claimed expenses were either reimbursable under the partnership agreement or not properly substantiated. Accordingly, all of the claimed deductions were disallowed and § 6662 accuracy related penalties were upheld.

6. The Empire strikes back against the "Millennium Plan." Goyak v. Commissioner, T.C. Memo. 2012-13 (1/11/12). The individual husband and wife taxpayers' wholly owned corporation, Goyak & Associates, contributed $1.4 million to a purported § 419A(F)(6) employee welfare benefit plan, known as the "Millennium Plan," of which the taxpayer husband was the sole beneficiary with respect to Goyak & Associates, and Goyak & Associates claimed a § 162 deduction. The Tax Court (Judge Goeke) held that the amount was a constructive dividend to Mr. Goyak, rather than a deductible ordinary and necessary business expense. The covered employee, i.e., Mr. Goyak, in the plan was able to (1) freely void his participation in the plan and have the life insurance policy maintained by the plan distributed to him, or (2) receive life benefits at a time of his choosing by "timing" a severance event. A 20 percent § 6662 accuracy-related penalty was upheld.

7. Reimbursement insurance is really a deposit. F.W. Services, Inc. v. Commissioner, 109 A.F.T.R. 2d 2012-676 (5th Cir. 1/25/12). The taxpayer, a temporary personnel agency, purchased insurance policies to cover workers compensation and employer's liability. The policies required the taxpayer to reimburse the insurer up to $500,000 for each claim. To provide evidence of financial responsibility to the insurer, the taxpayer entered into a second "insurance" contract to cover the reimbursement obligation. The second contract provided for an estimated premium of $3.9 million. The actual premium would be determined at the end of the policy year and provided for an increase or decrease in the amount owed depending upon experience. The taxpayer claimed a § 162 deduction for the full premium.

Upholding the Tax Court, the Circuit Court agreed with the IRS position that the premium paid was a non-deductible deposit on the taxpayer's potential reimbursement liability under the first policy. The court added that funds set aside for future reimbursement did not constitute insurance as there was no shift in the risk of loss.

8. Family commune farm provides deductible meals and medical care to its members. Stahl v. United States, 109 A.F.T.R.2d 2012-1507 (E.D. Wash. 3/20/12), *on remand from* 626 F.3d 520 (9th Cir. 2010). The Stahl family (consisting of eight siblings and spouses plus children numbering 65 people) maintains a Hutterite colony engaged in farming on 30,000 acres selling potatoes and dairy products. As participants in a § 501(d) nonprofit apostolic corporation, each member pays personal income tax on the member's pro rata share of the corporation's income, determined after allowable deductions. In a claim for refund the taxpayers asserted that their share of the corporate income should be reduced by deductions for the cost meals and payments for a health plan maintained by the corporation. On remand from the Ninth Circuit determination that the taxpayers were employees of the corporation, the District Court upheld the taxpayers' assertion that the corporate income of the colony is reduced by deductions for meals and the health plan. The court noted that it was necessary within the meaning of § 162 to maintain employees on the farm around the clock to maintain the dairy herd and found that food and medical care represented compensation to the employee family members who performed the work of the farm. The court stated that it was appropriate to treat the food and medical care as a form of "other compensation" deductible within the meaning of § 162(a)(1). The court also held that the medical insurance purchased by the corporation was a health plan within the meaning of Reg. § 1.106-1, excludable from income of the employee and deductible under Reg. § 1.162-10. The court rejected the IRS's argument that the food and health care were not deductible as personal expenses.

9. Don Draper likely would have tried to take advantage of this rule had it been around when he was renting hotel rooms in NYC. REG–137589–07, Local Lodging Expenses, 77 F.R. 24657 (4/25/12). Prop. Reg. § 1.162-31 would allow a deduction for local lodging, i.e., lodging while the taxpayer is not away from home, in carrying on a taxpayer's trade or business (whether or not as an employee) under a "facts and circumstances" test. One factor is whether the taxpayer incurs the expense because of a bona fide condition or requirement of employment imposed by the taxpayer's employer. (For employees the question usually is whether the employer-paid lodging is a working condition fringe benefit.) The proposed regulations provide a safe harbor for local lodging at business meetings and conferences. The examples indicate that there must be a bona fide business reason for the overnight stay, and, if provided by an employer, there must be a substantial noncompensatory reason. The regulations will be effective upon final publication, but pending finalization, taxpayers may rely on the proposed regulations.

- We foresee a deluge of future Tax Court cases involving deductions claimed for nights (or mid-day stays) at a host of no-tell motels.

10. Flying is entertainment, at least in the corporate aircraft. T.D. 9597, 77 F.R. 45480 (8/1/12), *corrected*, 77 F.R. 50373 (8/21/12). The Treasury Department has promulgated final regulations revising Reg. § 61-21(g)(14) and adding Reg. §§ 1.274-9 and 1.274-10, in addressing the disallowance of expenses under § 274(a) incurred in the use of taxpayer owned aircraft for entertainment. Under the regulations both fixed and variable expenses, including depreciation and interest expense, attributable to the use of taxpayer owned aircraft for entertainment are disallowed. Expenses are allocated on the basis of occupied seat miles or hours for entertainment travel relative to total seat miles or hours of aircraft use, or on a flight-by-flight basis. Expenses attributable to deadhead flights returning empty from an entertainment flight are included in the calculation. The Treasury Department rejected suggestions that expenses be determined on the basis of the primary purpose of a specific flight. Depreciation for the purpose of determining entertainment expenses may be calculated on a straight-line basis regardless of the depreciation method used by the taxpayer for other purposes. Aircraft with similar cost profiles that have the same type and number of engines can be aggregated in determining expenses allocable to use of the aircraft for entertainment. The regulations do not permit aggregation of the costs of all aircraft operated by the taxpayer. Expenses incurred for entertainment flights of specified employees (officers, directors, 10 percent owners) are excepted from disallowance under § 274(e)(2) only to the extent included in income as compensation by the recipient. Expenses in excess of the amounts included in income are disallowed. Also, expenses incurred to provide entertainment flights in taxpayer owned business aircraft to meet security concerns (which are excludable from the recipient's income as a fringe benefit) remain disallowed as deductions under § 274(a). The loss disallowance rules do not apply to expenses incurred by a commercial airline providing entertainment flights to "specified individuals" on a regularly scheduled flight on which 90 percent of the seats are offered for sale to the general public to the extent the entertainment flight is includable in the gross income of the specified individual.

11. The one who eats the food may not get the haircut: Proposed regulations allocate the § 274(n) limitations with respect to reimbursed meals. REG-101812-07, Reimbursed Entertainment Expenses, 77 F.R. 45520 (7/31/12). Section 274(n) limits otherwise allowable deductions for meals and entertainment to 50 percent of the expense. In the case of reimbursed meal or entertainment expenses that are not treated as income to the payor, § 274(e)(3) applies the limitation to the person claiming a deduction for the reimbursement. In *Transport Labor Contract/Leasing, Inc. v. Commissioner*, 461 F.3d 1030 (8th Cir. 2006), the court held that in a three-party reimbursement arrangement the § 274 limitation applied to the client who reimbursed an employee leasing company for meal expenses paid by the leasing company employer to contract truck drivers who were leased to a trucking company. The Eighth Circuit's opinion defined reimbursement arrangements by reference to definitions of an employer's accountable plan under § 62(a)(2)(A) and Reg. § 1.62-2. The proposed regulations would provide an independent definition of a reimbursement or expense allowance arrangement independent of the rules of § 62(a)(2)(A) and (c). Prop. Reg. § 1. 274-2(f)(2)(iv)(a)(D) (2012) would define a reimbursement arrangement as one under which an employee or independent contractor receives an advance, allowance, or reimbursement from an employer, client or contractor for expenses incurred by the recipient. A reimbursement plan involving payments to an independent contractor would have to be memorialized in a written agreement that identifies the party subject to the § 274 limitations.

- In the case of an employer, the limitations of § 274 apply to the employer's deduction of reimbursed expenses, except to the extent that the employer treats the reimbursement or other payment as compensation paid to the employee and wages for withholding purposes.
- In case of reimbursements to an independent contractor, the limitations apply to the independent contractor to the extent that the independent contractor does not account to the client or customer for meals and entertainment expenses under the substantiation rules of § 274(d). Where the independent contractor accounts for meal and entertainment expenses, the limitations are applicable to the client or customer. The person responsible for the § 274 limitations can be specified in a written agreement between the parties.
- The preamble to the proposed regulations and proposed examples indicate that in a multiple party arrangement each relationship will be treated as a two-party relationship subject to the independent contractor rules, which thus would impose the § 274 limitations upon the party that reimburses expenses substantiated to it by another party. Again, persons in multiparty reimbursement arrangements would be permitted to specify by agreement which party is subject to the § 274 limitations.

12. Cincinnati is one big metropolitan area. Saunders v. Commissioner, T.C. Memo. 2012-200 (7/17/12). The taxpayer worked for a single employer, had no principal place of business, and travelled directly from home to temporary work sites located between 74 and 96 miles away. The taxpayer lived in Manchester, Ohio [more than 70 miles away from Cincinnati], and indicated that his "main area" was Cincinnati. The Tax Court (Judge Thornton) refused to allow the taxpayer's claimed deductions for travel away from home as expenses incurred for travel outside the metropolitan area where the taxpayer lives and normally works. The court noted that the term "metropolitan area" is ill defined, but concluded under the facts

Back to Table of Contents

and circumstances that the taxpayer failed to establish that any of the temporary worksites to which the taxpayer travelled was outside of the Cincinnati metropolitan area; the two worksites identified in the opinion were 20 and 31 miles away from downtown Cincinnati, but were located within the Cincinnati-Middletown, OH-KY-IN Metropolitan Statistical Area as defined in OMB Bulletin No. 08-01 (Nov. 20, 2007).

13. Selling insurance is a service business not allowed a cost of goods sold, even to a former IRS agent. Perry v. Commissioner, T.C. Memo. 2012-237 (8/16/12). Along with denying unsubstantiated travel and business expenses (including $3,000 to an airline employee to be designated her “travel companion” for discounted airfare), the Tax Court (Judge Kroupa) held that the taxpayer’s business of selling insurance was not the sale of a material product to which direct cost may be allocated to reduce gross receipts as cost of goods sold.

14. IRS tries to put a lid on wages recharacterized as reimbursements. Rev. Rul. 2012-25, 2012-37 I.R.B. 337 (9/10/12). The IRS rules that certain employer arrangements that substitute reimbursement for tools, travel, supplies and the like under a purported “accountable plan” for compensation for services do not meet the business connection requirement of § 62(c) and therefore fail as accountable plans. The IRS notes that such plans are intended to avoid the two-percent limitation on deduction of employee business expenses and payment of employment taxes on wages that are recharacterized as reimbursements. Citing Reg. § 1.62-2(d), the ruling indicates with three factual situations that the business connection requirement is not met where hourly compensation is reduced and replaced with a reimbursement arrangement that pays the same gross amount to the employee regardless of whether the employee incurs deductible business expenses. The ruling states that the fact that the employee actually incurs a deductible expense in connection with employment does not cure the wage recharacterization. Second, a plan that pays the same amount of reimbursement to employees who have not actually incurred deductible expenses in connection with the employer’s business fails the business connection requirement. In situation 4 of the ruling, the IRS indicates that a plan that reduces hourly compensation but only reimburses employees who incur expenses in connection with the employer’s business and who are required to substantiate expenses qualifies as a reimbursement plan notwithstanding substitution for the reimbursement plan for a portion of the hourly compensation.

E. Depreciation & Amortization

1. No chickening out of the allocation agreement in an applicable asset acquisition – even after a cost segregation study. Peco Foods, Inc. v. Commissioner, T.C. Memo. 2012-18 (1/17/12). The taxpayer entered into an agreement with the sellers of two poultry processing plants that allocated a large portion of the purchase price to processing plants on which the taxpayer claimed depreciation deductions as nonresidential real property with a MACRS life of 39 years. Subsequently, after a cost segregation study, the taxpayer attempted to change its method of accounting to separate out components of the plants as equipment and machinery and claim accelerated depreciation on the basis of shorter MACRS recovery periods. The Tax Court (Judge Laro) held that under *Commissioner v. Danielson*, 378 F.2d 771, 775 (3d Cir. 1967) and § 1060 unless the taxpayer could show fraud, undue influence, duress, etc. the taxpayer was bound by the purchase price allocation agreement. The court rejected the taxpayer’s argument that nothing in § 1060 precluded the taxpayer from segregating components of assets broadly described as a production plant into components consisting of the real property and related equipment and machinery. The court also refused to accept the taxpayer’s assertion that the agreements with the sellers should be disregarded because the use of the terms “processing plant building” and “real property improvements” were ambiguous. Finally the court agreed with the IRS that the IRS did not abuse its discretion in prohibiting the taxpayer from adopting depreciation schedules that were inconsistent with the terms of the purchase agreements.

2. New accounting and disposition rules for MACRS property. T.D. 9564, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 76 F.R. 81060 (12/27/11), and REG-168745-03, Guidance Regarding Deduction and

Capitalization of Expenditures Related to Tangible Property, 76 F.R. 81128 (12/27/11). The capitalization and repair regulations (discussed above) provide significant new rules for the maintenance of multiple asset accounts and disposition of property from MACRS single and multiple asset accounts.

- *Accounting for MACRS property.* Consistent with prior rules under Reg. § 1.167-7, Temp. Reg. § 1.168(i)-7T allows taxpayers to account for MACRS property in a single asset account or by combining multiple assets in a multiple asset account. Assets in a multiple asset account must have been placed in service in the same taxable year, have the same recovery period and convention. Assets that are subject to different recovery rules or special limitations, such as automobiles, assets subject to additional first year recovery, or property used partly for personal purposes, may not be combined with assets subject to different recovery provisions. Assets with the same recovery periods and conventions may be combined in a multiple asset account even if the assets have different uses. In addition, the taxpayer is permitted to use as many single and multiple asset accounts as the taxpayer may choose.
- *Dispositions.* Temp. Reg. § 1.168(i)-8T(d) defines a disposition of MACRS property as occurring when the asset is transferred or permanently withdrawn from use in the taxpayer's trade or business or from the production of income. Thus, a disposition includes the sale, exchange, retirement, abandonment, or destruction of an asset. Significantly, the definition of disposition is expanded in the temporary regulation to include the retirement of a structural component of a building.
- *Gain or loss.* Gain or loss on the sale, exchange or conversion of an asset is determined under applicable tax principles. Loss on abandonment is determined from the "adjusted depreciable basis" of the asset (basis adjusted for depreciation). Temp. Reg. § 1.168(i)-8T(d). Recognized loss on other dispositions is the excess of the adjusted depreciable basis of the asset over fair market value. Identification of the asset disposed of from a multiple asset account, and its basis, is generally determined from the taxpayer's records. Temp. Reg. § 1.168(i)-8T(e) & (f). The temporary regulations provide rules for identifying assets if the taxpayer's records do not do so; a first-in first-out method, a modified FIFO method, a mortality dispersion table method, or any other method designated by the IRS. The asset cannot be larger than a unit of property. In case of a disposition of a structural component of a building, the structural component is the asset disposed of. An improvement placed in service after the asset is treated as a separate asset provided that it is not larger than the unit of property. Temp. Reg. § 1.168(i)-8T(c)(4)(ii)(E). Disposition of an asset in a single asset account terminates depreciation for the asset as of the time of the disposition. Disposition of an asset in a multiple asset account removes the asset from the account as of the beginning of the year of disposition, requires separate depreciation for the asset in the year of disposition, and reduction of the depreciation reserve of the multiple asset account by the unadjusted basis of the disposed asset as of the first day of the taxable year of the disposition. Temp. Reg. § 1.168(i)-8T(g).
- *General Asset Accounts.* Consistent with prior Reg. § 1.168(i)-1, the temporary regulations provide for an election to group assets into one or more general asset accounts. Temp. Reg. § 1.168(i)-1T(c)(2) provides for grouping assets in a general asset account as long as the assets have been placed in service in the same taxable year and have the same recovery period and convention. Assets that are subject to different recovery rules or special limitations, such as automobiles, assets subject to first year recovery, or property used partly for personal purposes, may not be combined with assets subject to different recovery provisions. The temporary regulations do not include the requirement of prior regulations that general asset accounts include only assets in the same asset class. Assets eligible for additional first year depreciation deductions must be grouped with assets eligible for the same first year depreciation deductions and may not be grouped with assets not eligible for additional first year depreciation. Temp. Reg. § 1.168(i)-1T(c)(2)(ii)(D) & (E). The temporary regulations expand existing rules for dispositions of assets from a general asset account to encompass as a disposition the retirement of a structural component of a building. As under existing rules, the temporary regulations treat the basis of any asset disposed of from a general asset account as zero, and any amount realized results in ordinary gain. The taxpayer continues to deprecate assets in the general asset account as if no disposition occurred.

Back to Table of Contents

Temp. Reg. § 1.168(i)-1T(e)(2). However, consistent with existing regulations, the temporary regulations allow a taxpayer to elect to terminate general asset account treatment on disposition of an asset in a qualifying disposition, in which case gain or loss is recognized under the rules of Temp. Reg. § 1.168(i)-8T. The list of qualifying dispositions is expanded generally to include any disposition. Temp. Reg. § 1.168(i)-1T(e)(3). In addition, general asset accounts are terminated in certain nonrecognition dispositions and on termination of a partnership under § 708(b)(1)(B). Gain or loss may also be recognized on disposition of all of the assets, or the last asset, in a general asset account. Temp. Reg. § 1.168(i)-1T(e)(3)(ii).

a. IRS specifies the procedures for adopting new accounting methods under the Temporary Regulations relating to depreciation of tangible property. Rev. Proc. 2012-20, 2012-14 I.R.B. __ (3/7/12), *modifying* Rev. Proc. 2011-14, 2011-1 C.B. 330. The IRS has provided lengthy and detailed rules regarding automatic changes in methods of accounting under Temp. Reg. §§ 1.167(a)-4T (amortizing or depreciating leasehold improvements), 1.168(i)-1T (rules for general asset accounts), 1.168(i)-7T (accounting for MACRS property), and 1.168(i)-8T (dispositions of MACRS property), all added by T.D. 9564, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 76 F.R. 81060 (12/27/11). The automatic change of accounting method of Rev. Proc. 2011-14, 2011-1 C.B. 330, is applicable to property placed in service in a taxable year ending after 12/29/03. With respect to assets placed in service in a taxable year ending before 12/30/03, adopting the methods of the temporary regulations requires an amended return for open years including the placed in service years and all subsequent years. No § 481 adjustment is required or permitted with respect to the amended returns.

b. LB&I provides guidance under Rev. Proc. 2012-20. LB&I-4-0312-004 (3/15/12). This directive to the field applies to taxpayers who adopted a method of accounting relating to the conversion of capitalized assets to repair expense under § 263(a).

3. Depreciation tables for business autos, light trucks, and vans. Rev. Proc. 2012-23, 2012-14 I.R.B. 712 (3/8/12). The IRS published depreciation tables with the depreciation limits for business use of small vehicles:

Passenger Automobiles with § 168(k) first year recovery,	
1st Tax Year	*$11,160*
2nd Tax Year	*$5,100*
3rd Tax Year	*$3,050*
Each Succeeding Year	*$1,875*
Trucks and Vans with § 168(k) first year recovery,	
1st Tax Year	*$11,360*
2nd Tax Year	*$5,300*
3rd Tax Year	*$3,150*
Each Succeeding Year	*$1,875*
Passenger Automobiles not eligible for § 168(k) first year recovery,	
1st Tax Year	*$3,160*
2nd Tax Year	*$5,100*
3rd Tax Year	*$3,050*
Each Succeeding Year	*$1,875*
Trucks and Vans not eligible for § 168(k) first year recovery,	
1st Tax Year	*$3,360*
2nd Tax Year	*$5,300*
3rd Tax Year	*$3,150*
Each Succeeding Year	*$1,875*

- The revenue procedure also has tables for leased vehicles.

Back to Table of Contents

4. More trouble for cost segregation studies in an opinion from a self-described "high plains drifter" (in which Judge Holmes does to the taxpayer something like what The Stranger did to Callie Travers). AmeriSouth XXXII, Ltd. v. Commissioner, T.C. Memo. 2012-67 (3/12/12). The Tax Court (Judge Holmes) rejected the taxpayer's attempt to use a cost segregation study to break down an apartment building and office complex into numerous components subject to MACRS cost recovery other than the 27.5 year straight line recovery attributable to residential real estate, in the process describing himself as a lone rider over the "llano estacado." The court described the property as "apartment buildings with over a thousand pieces of tangible personal property that just happen to be attached." Following a renovation, the taxpayer's cost segregation study broke down the property in to several categories including site preparation and earthwork; water-distribution system; sanitary-sewer system; gas line; site electric; special HVAC; special plumbing; special electric; finish carpentry; millwork; interior windows and mirrors; and special painting. The court rejected the IRS's argument that the taxpayer did not own a depreciable interest in the water and electric utility lines and gas distribution systems crossing the property in utility owned easements, but agreed with the IRS that the taxpayer did not have a depreciable ownership interest in the sewer lines on the property. The court rejected the taxpayer's assertion that site preparation costs were segregated depreciable assets subject to 15 year recovery saying that the taxpayer failed to overcome the presumption that the IRS correctly determined that the site preparation costs were non-depreciable improvements to land. The taxpayer failed to provide evidence that some of the costs were attributable to depreciable sidewalks, parking and driveways. After a lengthy analysis of rulings and case law, the court concluded that costs of installing water, gas, and electrical distribution systems between utility mains and the numerous buildings in the apartment complex constituted structural components of the buildings and thus were not subject to shorter MACRS recovery. The same fate befell venting connected to apartment stove hoods and HVAC systems – both structural components of the buildings; however, the clothes dryer vents have no connection to the general ventilation system and are separate property. While five year recovery was allowed for garbage disposals, connecting plumbing, sinks, plastic wash tubs, laundry room drains, and gas lines (excepting individual gas line connectors to dryers and stoves) were held to be part of providing general building services and were thus part of the building. The court agreed with the IRS that recessed lights, paddle fans with recessed lights, and wall outlets were all structural components. The court also held that finish carpentry (shelves, paneling, molding and the like), interior windows and mirrors, and special painting were all part of the building. In reaching all of these conclusions, the court refused to apply the holding in *Hospital Corp. of America v. Commissioner*, 109 T.C 21 (1997), which allowed segregation of certain rapidly depreciable tangible personal property that was not an inherently permanent structural component from the structural components of the hospital buildings in question in that case.

- Some have suggested that the precedential value of this decision might be limited because of the procedural aspects described by the court as follows:

> AmeriSouth sold Garden House about the time the case was tried, and stopped responding to communications from the Court, the Commissioner, and even its own counsel. We suspended briefing in an attempt to figure out what was going on and ended up ordering AmeriSouth to show cause why its attorneys should not be allowed to withdraw from its case. Without any response to the Court, we granted the attorneys' motion to withdraw and so AmeriSouth has been left representing itself. The Court then ordered AmeriSouth to file a posttrial brief, which it never did
>
> Because the Court ordered a posttrial brief and AmeriSouth didn't file one, we could dismiss this case entirely. …. Despite AmeriSouth's lack of response and mysterious disappearance, however, we will not do so. We will, though, deem any factual matters not otherwise contested to be conceded.

- On the other hand, it is a decided Tax Court case, and according to rumor, this case presages further Tax Court interest in the cost segregation studies area.

F. Credits

1. New markets credit is revised to help markets other than real estate. REG-101826-11, New Markets Tax Credit Non-Real Estate Investments, 76 F.R. 32882 (6/7/11). Section 45D allows a new markets tax credit for an equity investment at original issue in a community development entity (CDE), an entity that invests in qualified low income community projects. To encourage investments in projects other than real estate development, proposed regulations would reduce the requirement that returns on investments by a CDE be re-invested in community development projects during a seven year credit period. The proposed regulation would allow a CDE to reinvest capital from non-real estate businesses in unrelated certified community development financial institutions that are CDEs under § 45D(c)(2)(B) at various points during the seven-year credit period. The proposed regulations would allow an increasingly aggregate amount to be invested in certified community development financial institutions in the latter part of the seven year period.

a. Final regulations define an entity serving targeted populations for the new markets tax credit. T.D. 9560, Targeted Populations Under Section 45D(e), 76 Fed. Reg. 75774 (12/5/11). Section 45D provides a 5 percent credit each year for three years, then 6 percent for the subsequent three years for equity investment in a qualified community development entity. A qualified entity is a domestic corporation or partnership with a primary mission to serve or provide investment capital for low-income communities or persons that maintains accountability to the community with representation on its governing board and which is certified by Treasury as being a qualified community development entity. Qualified investment includes investment in a qualified active low-income community business, a business for which at least 50 percent of total gross income is derived from the active conduct of a qualified low income community business (including rental real estate) and a substantial portion of its property and services are within a low-income community. The maximum amount of investment qualified for the credit is an amount allocated to the community development entity from a pool that is limited to $3.5 billion for 2011, with nothing specified thereafter. § 45(f)(2). Following the proposed regulations and guidance contained in Notice 2006-60, 2006-2 C.B. 82, the final regulations, § 1.45D-1, provide that an entity will not qualify as an active low-income community business unless at least 50 percent of the entity's total gross income for any taxable year is derived from sales, rentals, services, or other transactions with individuals who are low income persons, at least 40 percent of the entity's employees are low-income persons, or at least 50 percent of the entity is owned by individuals who are low income persons. The regulations provide that an entity may determine the status of an individual as low income using any reasonable method including U.S. Census Bureau measures, HUD rules or income from Form 1040. Also, income derived from transactions with low income persons includes both payments made directly by low-income persons plus money and the fair market value of contributions of property or services provided to the entity primarily for the benefit of low income persons (provided that the contributor not receive a direct benefit). An entity whose sole business is rental real property will be treated as satisfying the 50 percent gross income requirement if the entity is treated as being located in a low-income community.

2. Save energy, save taxes. Notice 2012-22, 2012-13 I.R.B. 576 (2/23/12). Perpetually extended § 179D (through 2014 in the last iteration) allows a deduction of up to $1.80 per square foot for the cost of installing energy saving components if the total energy and power costs of a building are reduced by more than 50 percent compared to a reference building. A partial deduction is allowed for energy systems that do not meet the 50 percent threshold but satisfy a specified lowered requirement. The notice revises the percentage reductions figures of prior notices for the partial deduction for heating, cooling, ventilation, and hot water systems from 16 to 15 percent, from 16 to 25 percent for interior lighting, and from 16 to 10 percent for reductions attributable to the building envelope. Thus, the required percentage reductions in energy consumption for the partial deduction that are provided in the notice are 15 percent for HAVC systems, 25 percent for lighting, and 10 percent for the building envelope.

3. The Tax Court just says "no" to R&D credits claimed with 20/20 hindsight provided by alliantgroup. Shami v. Commissioner, T.C. Memo. 2012-78 (3/21/12).

The taxpayer's S corporation hired alliantgroup to conduct § 41 research tax credit studies covering the years in question. The research and development department staff ranged from 18 to 27 and included chemists, technicians and a vice president of research and development, who supervised the department. The alliantgroup concluded that the corporation was entitled to claim the § 41 research credit based in part on wages paid to two individuals who were, respectively, its chairman of the board, chief executive officer, president, and secretary (Shami), and its executive vice president and the sole member of its sales and marketing committee (McCall), neither of whom had formal education or training in any physical or biological science or engineering. The only issue in the case involved credits based on wages paid to the two executives. The taxpayers "failed to provide any documentation that establishe[d] how much time, if any, Mr. Shami or Mr. McCall spent performing research and development services during the relevant years," but argued that the court "must estimate the amount of wages allocable to qualified services if [it found] either Mr. Shami or Mr. McCall performed qualified services." The Tax Court (Judge Kroupa) rejected the taxpayer's argument, on the basis that the *Cohan* rule (*Cohan v. Commissioner*, 39 F.2d 540, 543-544 (2d Cir. 1930)) applies only if there is a reasonable basis on which the court can make an estimate, and that in this case the taxpayer failed to satisfy the court that there was sufficient evidence to estimate the appropriate allocation of wages between qualified services and nonqualified services. Judge Kroupa found *United States v. McFerrin*, 570 F.3d 672 (5th Cir. 2009), which did apply the *Cohan* rule in determining the § 41 research credit, to be inapposite, stating that in *McFerrin* "the Court of Appeals for the Fifth Circuit did not overrule, or even address, the basic requirement under *Cohan* that a court must have a reasonable basis upon which to make an estimate.

4. **You can't consume your supplies in research and sell them too.** Union Carbide Corp. v. Commissioner, 110 A.F.T.R.2d 2012-5254 (2d Cir. 9/7/12)Affirming the Tax Court, T.C. Memo. 2009-50, the Second Circuit (Judge Pooler) held that raw materials used in three discontinued research products that were ultimately converted to products sold by the taxpayer were not eligible for inclusion as part of qualified research expenditures for the 20 percent research credit of § 41(a). The court specifically held that the costs of supplies used during research projects that would have been used in the course of the taxpayer's manufacturing process regardless of the research do not qualify under §§ 41(b)(2)(A)(ii) and 41(h)(1)(B) as "an amount paid or incurred for supplies used in the conduct of research." The court, not willing to make "a fortress of the dictionary," determined that the phrase "used in the conduct of research" encompassed only supplies purchased for the purpose of conducting research, although supplies consumed in the normal manufacturing process were necessary to the research focused on more efficient methods of converting the raw materials to finished product. The court also noted that any ambiguity in the statute could be resolved by giving deference to the agency interpretation of the statute "even if that interpretation appears in a legal brief." The court found that the IRS's interpretation of the statute was consistent with the purpose of the research credit. In a concurring opinion Judge Pooler observed that if Congress had intended the supplies at issue to be creditable, it would have so provided in precise terms on a subject of industry lobbying.

5. **Gross receipts are not defined by the narrow definition of Black's Law Dictionary, the regulations provide better guidance.** Hewlett-Packard Company v. Commissioner, 139 T.C. No. 8 (9/24/12). For the tax years at issue the taxpayer elected the alternative incremental research credit (AIRC) method of computing the § 41 research credit, which provided a credit equal to the sum of: (i) 2.65% (1.65% for 1999) of so much of the qualified research expenditures (QRE) from the tax year as exceeded 1% of annual adjusted gross receipts (AAGR), but did not exceed 1.5% of those AAGR; (ii) 3.2% (2.2% for 1999) of so much of the QRE from the tax year as exceeded 1.5% of AAGR, but did not exceed 2% of those AAGR; and (iii) 3.75% (2.75% for 1999) of so much of the QRE from the tax year as exceeded 2% of AAGR. In 1999 Treasury proposed regulations to provide that adjusted gross receipts for this purpose include in addition to sales receipts (as adjusted for returns and allowances) other sources of gross income such as interest, dividends and rents. The final regulations adopted the provision but with an effective date for tax years beginning after the date of the final regulations, 1/3/01. For its tax years 1999 through 2001 the taxpayer calculated its credit on the basis of

adjusted gross receipts that did not include income other than sales income. The Tax Court (Judge Goeke) concluded that the final regulations were a proper interpretation of the statutory language and legislative intent and that the Treasury's logic in embracing a definition of gross receipts as articulated in the preamble to the proposed regulations applies to taxable years preceding the effective date of the regulations. Thus the court adopted a definition of gross receipts that includes the total amount derived by a taxpayer from all activities and sources. The court rejected the taxpayer's argument that by adopting § 41(c)(4) (excluding "returns and allowances" from gross receipts), Congress indicated an intent to limit the concept of gross receipts for § 41 purposes to sales receipts. The court also refused to adopt a narrow "common law meaning" of gross receipts from Black's Law Dictionary as undermined by numerous statutory authorities using the term. Further, the court indicated that the maximum "*expressio unius est exclusio alterius*" applies to indicate that congressional enumeration of specific exceptions to gross receipts means that other exceptions are not to be implied.

G. Natural Resources Deductions & Credits

H. Loss Transactions, Bad Debts, and NOLs

1. IRS expands its rescue of Bernie Madoff's Ponzi scheme victims to include death. Rev. Proc. 2011-58, 2011-50 I.R.B. 849 (11/28/11). In Rev. Proc. 2009-20, 2009-1 C.B. 749, the IRS provided a safe harbor under which qualified investors are allowed to treat a lost investment in a Ponzi scheme as a theft loss deduction. Among the condition in the safe harbor is a requirement that the perpetrator of the scheme be charged with criminal theft. Inconveniently, the IRS notes that the lead figure in some of these cases has avoided indictment by dying. Thus, the requirement of Rev. Proc. 2009-20 is amended to provide for indictment, information, or state complaint charging theft that has not been withdrawn for reasons other than the death of the lead figure.

I. At-Risk and Passive Activity Losses

1. Borrowed funds contributed to S corporation cellular company were neither at-risk nor did they create basis for loss deductions. Broz v. Commissioner, 137 T.C. 46 (9/1/11). In a structure typical for the industry, the taxpayer was the shareholder of two S corporations, RFB and Alpine, that held FCC licenses to operate cellular networks in rural areas. RFB held licenses directly and was the original business. Alpine was formed to expand the business and held the licenses through a number of single-owner LLCs. Alpine and the LLCs were formed at the insistence of creditors to isolate the liabilities of the thinly capitalized expansion. RFB owned and operated all of the equipment. Alpine and its LLCs owned only licenses, and RFB allocated some its income to Alpine for use of the licenses. RFB obtained financing to construct cellular equipment and for working capital, and re-lent some of the loan proceeds to Alpine. Alpine and the taxpayer documented the loans from RFB to Alpine as shareholder loans. The taxpayer pledged RFB stock for the loans, but did not guarantee the loans, which were also secured by corporate assets.

- First, for purposes of determining the taxpayer's basis in Alpine, for purposes of applying the § 1366(d) limitation on passed-through losses, the court (Judge Kroupa) held that (1) the taxpayer had not established that he had borrowed money from the bank that he personally re-lent to Alpine because RFB did not advance the funds to Alpine on the taxpayer's behalf, i.e., the loan ran directly from RFB to Alpine; and (2) the taxpayer had not made any "economic outlay." Thus, the loans were not included in the shareholder's basis to support loss deductions.

- Second, for purposes of determining the taxpayer's at-risk amount with respect to Alpine, in what was described as an issue of first impression, the court held that the RFB stock pledged for the loans represented pledged property used in the business not eligible to be treated as an amount at-risk by virtue of § 465(b)(2)(A). Since Alpine was formed to expand RFB's cellular networks, the pledged RFB stock was related to Alpine's business. Thus, because the shareholder did not guarantee the loans to Alpine, the shareholder was not economically or actually at-risk with respect to his involvement with Alpine.

- Third, the court held that Alpine could not deduct interest, expenses, and depreciation during the years at issue because it was not yet engaged in an active trade or business utilizing the licenses it held. The court rejected the taxpayer's argument that operation of cellular networks by RFB could be attributed to Alpine. Acquisition of licenses and related equipment was not sufficient to establish Alpine as engaged in the active conduct of a trade or business. Alpine failed to attach the required statement to the return for the taxable year to claim § 195 amortization of start-up expenses [which it could not have deducted even if it had attached the form because it had not yet commenced business operations].

- Fourth, in another issue that the court described as one of first impression, the court concluded that deductions under § 197 for amortization of the costs of FCC licenses were not available in years in which the taxpayers was not yet engaged in a trade or business. The court concluded that the language of § 197 that provides the deduction "in connection with the conduct of a trade or business" requires that the intangibles "must be used in connection with a business that is being conducted."

2. **This taxpayer piloted ships over the bar of the passive activity loss limitations.** Miller v. Commissioner, T.C. Memo. 2011-219 (9/18/11). Taxpayer was a San Francisco Bay Bar Pilot, which means that he piloted commercial ships in and out of San Francisco Bay over the shallow bar that blocks entrance to the Bay as a partner in the San Francisco Bay Bar Pilots Association. In addition taxpayer served as the contractor on the construction of rental real estate which he and his wife also managed. The taxpayer convinced the court (Judge Kroupa) that he spent more time in real estate activities ["in which he materially participate[d]"] than he did in piloting ships, and that he met the 750 hour requirement [by "performing services … in real property trades or businesses in which [he] materially participate[d]"] under § 469(c)(7) to qualify as a real estate professional entitled to claim real estate losses without limitation to passive activity income under § 469. However, the taxpayer failed to elect under § 469(c)(7)(A) to treat all of his real estate activities as a single activity. The court found that the taxpayer was a material participant in only two of his six real estate properties having participated more than 100 hours in each activity, which was more than any other participant. The taxpayer failed to establish that he met the 100 hour requirement or that his participation was more than other participants in four properties. The court rejected the IRS imposition of § 6662 accuracy related penalties.

3. **A song and a dance doesn't make the law practice a professional real estate business, but renting your building to the law practice is active.** Langille v. Commissioner, T.C. Memo. 2010-49 (3/18/10). The taxpayer Deanna Langille, formerly known as Deanna Birdsong, worked long hours in her law practice and devoted somewhat less of her time to her rental real estate activities. Unfortunately for the taxpayer she resigned from her law practice in lieu of disciplinary proceedings implemented for misappropriation of funds from her firm's client trust accounts. To make matters worse, after an unsuccessful negotiation for the sale of her law practice, the potential buyer reported to the IRS that the taxpayer maintained two sets of books for the practice, which resulted in a criminal investigation and a guilty plea to one count of a tax fraud indictment. In the civil tax matter the Tax Court (Judge Gustafson) found that the taxpayer willfully failed to report income from her law practice and residential real estate rental activities (from which she had no profit). The taxpayer was unable to establish the number of hours she worked on her residential real estate activities and thus was unable to establish herself as a real estate professional under the 50 percent of all personal services requirement of § 469(c)(7)(B)(i) or that she satisfied the 750 hour requirement of § 469(c)(7)(B)(ii). In addition, the court held that income from the taxpayer's rental of office space to her law practice in which she was a material participant was not passive activity income under Reg. § 1.469-2(f)(6).

a. **The Eleventh Circuit sings the same tune but without making a recording.** Langille v. Commissioner, 447 Fed. Appx. 130 (11th Cir. 11/22/11). In an unpublished per curiam opinion, the court affirmed the Tax Court in spite of the court's statement that it construes briefs of pro se litigants liberally.

4. **Limited liability doesn't necessarily mean limited partner.** REG-109369-10, Passive Activity Losses and Credits Limited, 76 F.R. 72875 (11/28/11). The Treasury has published proposed amendments to Reg. § 1.469-5, dealing with the definition of

an "interest in a limited partnership as a limited partner" for purposes of determining whether a taxpayer materially participates in an activity under § 469. Prop. Reg. § 1.469-5(e) would eliminate the current reliance (in Temp. Reg. § 1.469-5T(e)(3)) on limited liability for determining whether an interest is an interest in a limited partnership as a limited partner under § 469(h)(2) and replace it with an approach that relies on the individual partner's right to participate in the management of the entity. Specifically, Prop. Reg. § 1.469-5(e)(3) would provide that "an interest in an entity shall be treated as an interest in a limited partnership as a limited partner if ... [t]he holder of such interest does not have rights to manage the entity at all times during the entity's taxable year under the law of the jurisdiction in which the entity is organized and under the governing agreement." A right to manage includes authority to bind the entity. Furthermore, an individual who holds a limited partnership interest would not be treated as holding a limited partnership interest if the individual also holds an interest in the partnership that is not a limited partnership interest as defined in Prop. Reg. § 1.469-5(e)(3). The regulations will be effective upon promulgation of final regulations

a. But you really don't have to wait to claim the benefit of this concession. Limited Liability Partnership and Limited Liability Company membership interests are not presumptively limited partnership interests under the passive activity loss rules. Garnett v. Commissioner, 132 T.C. 368 (6/30/09). The taxpayers held a number of direct and indirect interests in limited liability partnerships and LLCs that were engaged in agribusiness. Section 469(h)(2) provides that a limited partnership interest will not be treated as an interest with respect to which a taxpayer is a material participant, except as provided in regulations. Temp. Reg. § 1.469-5T(e)(2) provides that a limited partner materially participates in a partnership activity only if (1) the taxpayer devotes more than 500 hours to the activity in the year, (2) the taxpayer materially participates in the activity for five of the preceding ten taxable years, or (3) the activity is a personal service activity in which the taxpayer materially participated for any three preceding years. Temp. Reg. § 1.469-5T(e)(2)(1), (5), (6). Temp. Reg. § 1.469-5T(e)(3) defines a limited partnership interest as an interest designated as a limited partner interest in a partnership agreement or an interest for which the partner has limited liability. Temp. Reg. § 1.469-5T(e)(3)(ii) has an exception from the material participation rule for an interest of a limited partner who also holds a general partnership interest. The court (Judge Thornton) concluded that in the case of an interest in a limited liability partnership or a limited liability company, both of which the court described as different from a limited partnership, the interests are not to be treated as limited partnership interests under § 469(h)(2). Holders of such interests are not barred by state law from materially participating in the affairs of the entity and thus hold their interests as general partners within the meaning of the temporary regulations. Thus, whether or not the taxpayer is a material participant requires a full factual inquiry and an LLC member can satisfy the material participation requirement under any of the seven tests in Temp. Reg. § 1.469-5T(a).

b. The Court of Federal Claims agrees. Thompson v. United States, 87 Fed. Cl. 728 (7/20/09). The court (Judge Block) granted summary judgment treating the taxpayer member/manager of an LLC as a material participant. The taxpayer's degree of participation was stipulated and the only question was whether § 469(h)(2) precluded treating the taxpayer as a material participant in a Texas LLC. The court noted that § 469(h)(2) treats limited partners differently because of an assumption that limited partners do not materially participate in their limited partnerships. In an LLC, on the other hand, all members have limited liability but members may participate in management. The court noted that Temp. Reg. § 1.469-5T(e)(3) treats a partnership interest as a limited partner interest if the holder has limited liability "under the law of the State in which the partnership is organized." The court held that the quoted language applies only to an entity that is a partnership under state law, which does not include an LLC, which, although treated as a partnership for tax purposes, is a different type of entity under state law. The taxpayer was both a member and manager of the LLC. Unlike a limited partner, a member manager does not lose limited liability by participation in the management of the LLC. The court also recognized that shareholders of an S corporation have limited liability as shareholders, but participate in management, and are not subject to being automatically treated as passive participants. The taxpayer, therefore, was able to demonstrate his material participation in the activity by using all seven of the Temp. Reg. § 1.469-5T(a) tests.

c. Ditto. Newell v. Commissioner, T.C. Memo. 2010-23 (2/16/10). Relying on Garnett v. Commissioner, *supra*, Judge Marvel held that the interest of a managing member of a California LLC was not a limited partnership interest for purposes of Reg. § 1.469-5T(c)(1). Taxpayer's losses were not passive activity losses because the IRS conceded that the taxpayer met the "significant participation" test of Temp. Reg. § 1.469-5T(a)(4).

d. The IRS acquiesces. AOD 2010-02, 2010-14 I.R.B. 515 (4/5/10). The IRS acquiesces in the result in Thompson.

5. Vandegrift v. Commissioner, T.C. Memo. 2012-14 (1/12/12). The taxpayer, who was employed as a salesman, invested in nine rental properties. Six of the properties were rented. The taxpayer acquired three properties for rental after renovations were completed, but sold the properties before they were rented. The Tax Court (Judge Goeke) held that the taxpayer failed to establish that he was a real estate professional under § 469(c)(7), because the taxpayer was unable to provide contemporaneous verification of the time he devoted to the real estate activity. The court also held that the taxpayer's rental real estate activity was a passive trade or business that included all nine properties. Thus, the taxpayer was permitted to offset losses from the rental properties against the capital gain recognized on the sale of three properties. The court rejected the IRS's argument that since the three properties that produced short-term capital gain were never rented the gain could not be offset by the losses.

6. Yeah, it's true – Ya really do gotta keep records of hours worked. Iversen v. Commissioner, T.C. Memo. 2012-19 (1/18/12). The Tax Court (Judge Swift) held that the taxpayer failed to prove he had satisfied the 500 hour participation test of Reg. § 1.469-5T(a)(1) in the operation of a Rocky Mountain cattle ranch that was principally run by a resident manager. Evidence of eleven trips (along with his children) to the ranch (which had a 20,000 square foot lodge) in a private plane funded by the taxpayer's successful medical supplies business and telephone conversations with the ranch manager did not convince the court that the taxpayer was a material participant. In addition, the court concluded that much of the taxpayer's activities were in the capacity of an investor, which do not qualify as participation under Reg. § 1.469-5T(f)(2)(ii)(A) and (B). The court did not sustain accuracy related penalties on the ground that the taxpayer reasonably relied on his accountant to prepare the returns.

7. Self-rent to the taxpayer's business was not passive income. Samarasinghe v. Commissioner, T.C. Memo. 2012-23 (1/19/12). Applying Reg. § 1.469-2(f)(6), the Tax Court (Judge Marvel) held that income from the taxpayer's rental of a building owned by the taxpayer, which was used in the taxpayer's medical practice was not passive activity income that could be offset with the taxpayer's losses from passive activities. The court also held that, under New Jersey state law, the original lease for the medical building entered into in 1980 was not subject to the transitional rule of Reg. § 1.469-2(f)(6), which is not applicable to binding contracts entered into before 1988. The court determined that the original lease had been ignored by the parties and not followed in the 2004 through 2009 time period at issue in the case. The court refused to impose § 6662 penalties because it found that the taxpayers reasonably relied on their tax advisor with respect to the treatment of the lease payments.

8. When good at-risk notes go bad there are tax consequences to the maker. Zeluck v. Commissioner, T.C. Memo. 2012-98 (4/3/12). In 2001, the taxpayer invested in an oil and gas partnership, investing $310,000 – $110,000 of cash and $200,000 in the form of a subscription promissory note. He was initially at risk for $310,000, because the debt obligation was "genuine" through 2002, but by 2003, when the partnership terminated, his at-risk amount had been reduced to zero as a result of receiving passed-through losses and distributions totaling $310,000. After he had reduced his at-risk amount at risk to zero, upon the termination of the partnership in 2003 his liability for the $200,000 note became "nongenuine." No principal payments had been made to the partnership and there was no evidence that the note was transferred or distributed to anyone upon dissolution of the partnership. After the termination of the partnership, there was no person or entity to which the taxpayer was liable for payment on the subscription note. He never received any written notification of the balance due on the subscription note, made no inquiry regarding the balance due, and has made no arrangements to pay the balance due. No demand for payment was made by any party as a result of the subscription notes, even after the due date. The taxpayer never signed an extension of the subscription note or otherwise pushed back the maturity date. As a result of the note becoming nongenuine, under § 465(b)(2) the taxpayer's at-risk amount was reduced to negative $200,000 in 2003. Thus, the Tax Court (Judge Goeke) decided that the taxpayer recognized a $200,000 gain for 2003 pursuant to § 465(e).

- The 20 percent accuracy-related penalty under § 6662(a), imposed for taxpayer's negligence in failing to reduce his amount at risk, was upheld by the court.

9. The Tax Court shines some light on passive solar energy installations. Wilson v. Commissioner, T.C. Memo. 2012-101 (4/10/12); Uyemura v. Commissioner, T.C. Memo. 2012-102 (4/10/12); Lum v. Commissioner, T.C. Memo. 2012-103 (4/10/12). In three nearly identical opinions the Tax Court (Judge Cohen) held that losses from a micro-utility activity involving purchase and rental of solar equipment were passive activity losses. The taxpayers each purchased photovoltaic systems from a company doing business in Hawaii as Mercury Solar. Under the program, the taxpayer also acquired an investment solar system that was installed at the residence of a ratepayer, who paid a monthly fee to purchase the energy produced by the investment system. Each taxpayer acquired a single investment system that was installed in the residence of the "ratepayer." The system was installed at the ratepayer's residence by Mercury Solar. The taxpayer contracted with another company to collect the monthly payments on behalf of the taxpayer as the equipment owner. The collection company maintained records and made payments on the taxpayers' loans to acquire the equipment. The court rejected the taxpayers' assertions that they qualified as material participants as the persons engaged in substantially all of the participation in the activity and held that that the taxpayers failed to meet their burden of proving that they participated in the activity for more than 100 hours, which was not less than the participation of any other individual. See Temp. Reg. § 1.469-5T(b)(2). The court noted that the participation of Mercury Solar and the collection company were also substantial. In the absence of material participation by the taxpayers in the three cases, the court did not need to consider whether the activity was a rental activity. In addition to disallowing deductions for losses under § 469, in *Uyemura* and *Lum* the court disallowed the taxpayers' claims for the § 48 business energy credit not subject to the passive activity loss limitation because the taxpayers had no tax liability with respect to the micro-utility and because no § 38 general business credits are allowable with respect to property for which a § 179 election to expense business assets is made.

10. The taxpayer loses, but not as badly as he would have had the IRS properly argued the case. Veriha v. Commissioner, 139 T.C. No. 3 (8/8/12). The taxpayer was the sole owner of JVT, a C corporation that conduced a trucking business in which he actively participated. JVT leased the tractors and trailers used in its business from TRI, an S corporation in which the taxpayer owned 99 percent of the stock, and JRV, a single-member LLC wholly owned by the taxpayer and thus a disregarded entity. Each lease of a tractor or trailer was governed by a separate contract. During the year in issue, TRI realized net income and JRV realized a net loss. The taxpayer treated the net income from TRI as passive income and treated the net loss from JRV as a passive loss. The IRS determined that pursuant to Reg. § 1.469-2(f)(6) — the self-rental recharacterization rule — each tractor and each trailer should be considered a separate "item of property" and that the income the taxpayer received from TRI should be recharacterized as nonpassive income, while the net loss realized by JRV remained a passive activity loss. Reg. § 1.469-2(f)(6) provides as follows: "An amount of the taxpayer's gross rental activity income for the taxable year from an item of property equal to the net rental activity income for the year from that item of property is treated as not from a passive activity if the property— (i) Is rented for use in a trade or business activity ... in which the taxpayer materially participates ... ." The Tax Court (Judge Wells) rejected the taxpayer's argument that all of the tractors and trailers collectively were one "item of property," and looking to *Webster's Third New International Dictionary* 1203 (2002) for the definition of the term "item" held that for purposes of applying Reg. § 1.469-2(f)(6), each individual tractor or trailer was an "item of

Back to Table of Contents

property," and the income received from TRI was subject to recharacterization. However, because the IRS had not contested the taxpayer's netting of gains and losses within TRI, only TRI's net income was recharacterized as nonpassive income that could not be offset by losses from JRV.

- Judge Wells noted that the result was more favorable to the taxpayer than the result would have been if the IRS had taken the position — which was consistent with Judge Well's analysis of the meaning of the regulations — that the income from each tractor or trailer within TRI and JRV should have been recharacterized as nonpassive.

III. INVESTMENT GAIN AND INCOME

A. Gains and Losses

1. Getting ripped off by Bernie Ebbers wasn't a theft loss. Schroerlucke v. United States, 100 Fed. Cl. 584 (9/21/11). In an opinion that was far longer than necessary to employ a well-established principle to resolve the case, the court held that the loss of value of stock, purchased pursuant to employee stock options, in WorldCom (from $79.4375/share to $0.91/share) caused by Bernie Ebbers/WorldCom's fraudulent accounting practices was not a theft loss. There was no theft under relevant state law, which is prerequisite to § 165 theft loss.

2. ♪♫"Lipstick on your collar told a tale on you."♫♪ Anschutz Co. v. Commissioner, 135 T.C. 78 (7/22/10). An S corporation, through a Q-Sub (TAC) entered into transactions with Donaldson, Lufkin & Jenrette Securities (DLJ) involving appreciated stock that it owned. The agreements were memorialized by a master stock purchase agreement (MSPA) that included "Prepaid Variable Forward Contracts" (PVFCs) and share-lending agreements (SLAs) with respect to the shares subject to the PVFCs. The PVFCs required DLJ to make an upfront payment to TAC in exchange for a promise by TAC to deliver a variable number of shares to DLJ in ten years. The amount of the payment was 75 percent of the fair market value of the shares subject to the PVFCs. If the stock subject to the PVFCs appreciated over the term of the contract, TAC was entitled to retain 50 percent of the appreciation, and the remainder accrued to DLJ. TAC pledged the shares of stock at issue in the PVFCs as collateral for the upfront payment and to guarantee TAC's performance under the PVFC. The pledged shares were delivered to a trustee. Before each stock transaction DLJ executed short sales of that stock in the open market. After TAC lent shares to DLJ pursuant to the SLAs, DLJ used the shares to close out the short sales. TAC received upfront payments under the PVFCs totaling $350,968,652 and $23,398,050 in prepaid lending fees under the SLAs.

- The taxpayer claimed that TAC executed two separate transactions – PVFCs and SLAs – and neither constituted a current sale for tax purposes, relying, in part, on § 1058. The Tax Court (Judge Goeke) agreed with the IRS that the shares subject to the PVFCs and lent pursuant to the SLAs were sold for income tax purposes. The transaction consisted of two integrated legs, one of which called for share lending, but the two legs were clearly related and interdependent. Analyzing the MSPA as a whole, in exchange for valuable consideration TAC transferred to DLJ the benefits and burdens of ownership, including (1) legal title to the shares; (2) all risk of loss; (3) a major portion of the opportunity for gain; (4) the right to vote the stock; and (5) possession of the stock. Although the SLAs provided that TAC could terminate share loans and recall the shares, in reality any share recalls were really TAC borrowing shares from DLJ. Because DLJ closed out its original short sales with the lent shares, the shares later transferred to TAC were in substance DLJ borrowing shares from third parties and delivering them to TAC. Gain was recognized with respect to the upfront cash payments received in the transactions. The taxpayer's reliance on § 1058 was rejected because the taxpayer's argument relied on the premise that the PVFCs were separate from the SLAs. The MSPA violated the requirement of § 1058(b)(3) that the agreement not limit the lender's risk of loss or opportunity for gain, because the agreements eliminated TAC's risk of loss with regard to the lent shares.

- On the bright side ☺, Judge Goeke rejected the IRS's alternative argument that the transactions were also either a constructive short sale by TAC under § 1259(c)(1)(A) or a constructive forward contract sale under § 1259(c)(1)(C). TAC did not enter into any short sale because DLJ was acting as a principal and not as an agent in making the short sales. The transactions were not constructive forward contract sales because they were not forward contracts as defined in § 1259(d)(1) in that they did not provide for delivery of a substantially fixed amount of property for a substantially fixed price.

- The transaction in *Anschutz Co.* occurred before the issuance of Rev. Rul. 2003-7, 2003-1 C.B. 363, in January 2003. That ruling offered a roadmap to avoidance of gain recognition although a collar around unrealized appreciation was achieved.

a. **"Not only did DLJ effectively obtain and dispose of the actual shares pledged by TAC, TAC received significant value for those shares and simultaneously lost nearly all of the incidents of ownership of those shares."** Anschutz Co. v. Commissioner, 664 F.3d 313 (10th Cir. 12/27/11). In affirming the Tax Court's decision, the Court of Appeals applied the principles from *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237 (1981) – "the term 'sale' is given its ordinary meaning and is generally defined as a transfer of property for money or a promise to pay money" – and relied on factors listed in *H.J. Heinz Co. and Subsidiaries v. United States*, 76 Fed. Cl. 570, 581 (2007): "(1) Whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity interest in the property was acquired; (4) whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (5) whether the right of possession is vested in the purchaser; (6) which party pays the property taxes; (7) which party bears the risk of loss or damages to the property; and (8) which party receives the profits from the operation and sale of the property." The court continued that with respect to stock transactions in particular, the following factors are also considered relevant to this determination: "(i) whether the purchaser bears the risk of loss and opportunity for gain; (ii) which party receives the right to any current income from the property; (iii) whether legal title has passed; and (iv) whether an equity interest was acquired in the property." Looking at the transactional documents, the Court of Appeals concluded that the transaction "effectively afforded DLJ all incidents of ownership in the pledged and borrowed shares, including the right to transfer them." Given the specifics of the underlying agreements, the court did not assign much weight to the fact the parties treated the transactions as executory contracts for the sale of shares to DLJ, rather than current sales of the shares. As for the third factor, DLJ obtained an equity interest in the shares because it had the right to do as it saw fit with them. TAC received (a) upfront cash equal to 75 percent of the pledged stock's then-existing market value, (b) a 5 percent prepaid tranche fee, (c) the potential of benefitting to a limited degree if the pledged stock increased in value over the life of the transactions, and (d) the complete elimination of any risk of loss. The fourth, fifth, and seventh factors were easily satisfied on the facts. (The sixth factor was not relevant.) Looking at the eighth factor, the court noted that "TAC had significantly less ... price reward from the ... shares [at issue] by executing [the transactions] than it would have [had] by simply holding onto the shares and selling them after ten years." In addition, the court noted that TAC effectively transferred the voting rights, had only limited rights to received dividends or dividend equivalent payments, and gave "DLJ the right to possess, and ultimately dispose of, the shares."

- The court rejected the taxpayer's argument that the taxpayer's transaction was "substantially identical" to the one in Revenue Ruling 2003-7, 2003-1 C.B. 363, and that, consequently, "the transactions at issue should not be treated as current sales of TAC's shares to DLJ." Unlike Revenue Ruling 2003-7, which involved only a variable prepaid forward contract, the transaction in the instant case also included a master stock purchase agreement and share lending agreement. The result was that that "DLJ obtained possession, and most of the incidents of ownership, of TAC's pledged shares. TAC, in turn, obtained cash payments and an elimination of any risk of loss in the pledged stock's value at the end of the term of the transactions."

- Finally, the court rejected the taxpayer's argument that the transaction was protected by the so-called "safe harbor" § 1058. To qualify as a loan of securities under § 1058, the loan agreement must (1) provide for the return to the lender of identical securities, (2) require payments to the lender equal to all interest, dividends, and other distributions on the securities during the period of the loan, and (3) not reduce the risk of loss or opportunity for gain of the transferor of the securities in the securities transferred. Section 1058 did not apply because the transactions did not satisfy the requirements of § 1058(b)(2) and (3): The transactions at issue did not ensure that TAC would receive amounts equivalent to all interest, dividends, and other distributions to which TAC was otherwise entitled on the pledged stock, and the transactions effectively reduced TAC's risk of loss and opportunity for gain on the pledged shares.

b. No ring-around-the-collar here: This collar just plain clean works. Rev. Rul. 2003-7, 2003-1 C.B. 363 (11/16/03). The IRS ruled that a shareholder has neither sold stock currently nor caused a constructive sale of stock under § 1259 where he (1) receives a fixed amount of cash, (2) simultaneously enters into an agreement to deliver on a future date a number of shares of common stock that varies significantly depending on the value of the shares on the delivery date [but which does provide a "collar" on the number of shares of stock to be delivered, in effect providing a "collar" on the ultimate sale price], (3) pledges the maximum number of shares for which delivery could be required, (4) has the unrestricted right to deliver the pledged shares or to substitute cash or other shares on the delivery date, and (5) is not economically compelled to deliver the pledged shares.

- There was not a sale of the pledged shares because the shareholder was not required to relinquish the pledged shares but had an unrestricted right to reacquire them by delivering cash or other shares. There was not a constructive sale under § 1259(c)(1)(C) because due to the variation in the number of shares that might be delivered, the agreement was not a contract to deliver a substantially fixed amount of property for purposes of § 1259(d)(1).

3. Section 1221(a)(1) says "to customers in the ordinary course of business" (emphasis added), not "to a customer." Bennett v. Commissioner, T.C. Memo. 2012-193 (7/12/12). The taxpayer was a "serial entrepreneur" who constructed a single residence for purposes of resale at profit, but which he sold at a substantial loss after five years. The Tax Court (Judge Wherry) upheld the IRS's determination that the residence was a capital asset, not property held for sale to customers in the ordinary course of business described in § 1221(a)(1), thereby denying ordinary loss treatment and subjecting the loss to § 1211 limitations. The taxpayer was not a real estate broker, had never before (or after) dealt in real estate, and did not have a contract to sell the property in place when he commenced construction. He did not meet the burden of showing that the real estate activity was a trade or business rather than an investment.

4. The taxpayer lost his claim that a qui tam relator's reward for ratting out HCA for Medicare fraud was a capital asset, while in the meanwhile the alleged mastermind of the HCA Medicare fraud scheme won the Florida gubernatorial race. Alderson v. United States, 686 F.3d 791 (9th Cir. 7/18/12). The taxpayer was a qui tam relator who filed a refund claim based on the argument that his share of the government's recovery (16 percent of $631 million) from the Hospital Corporation of America, Inc. (and several medical providers related to HCA) for Medicare fraud as capital gains rather than ordinary income. When Alderson, who was the CFO of an HCA related corporation (Quorum), was asked to prepare two sets of books, one for the hospital's financial auditors and one to serve as the basis for the hospital's Medicare cost reports, he refused to prepare separate books and was fired. Using information obtained during discovery in his wrongful termination suit, Alderson filed a qui tam suit against Quorum, HCA and affiliated companies under the False Claims Act (31 U.S.C. §§ 3729 et seq.). Alderson made available to the United States the documents he had received during discovery, and eventually the government intervened in the suit. The Ninth Circuit (Judge Fletcher) affirmed the District Court's holding for the government. First, the court rejected the taxpayer's claim that he "'exchanged his documents, information and know-how[ ] and ... received cash, thus consummating a sale or exchange ...," reasoning that the taxpayer "did not 'sell' or 'exchange' his information.'" His right to a relator's share for pursuing his qui tam suit that was conferred by the FCA was subject to a statutory precondition that he share his information with the government. Second, the information regarding HCA and its affiliates was not the taxpayer's "property." The taxpayer had no legal right to exclude others from use of the information, the information was known to other officials in the companies, and the taxpayer had no right to prevent those officials from providing the information to others. The court also rejected the taxpayer's argument that his relator's share, which he argued appreciated in value from the time he filed his suit until he received payment, was the relevant capital asset. The taxpayer had no "underlying investment of capital," and the increase in value "did not 'reflect an accretion in value over cost to [the] underlying asset.'" The taxpayer "was not an investor who bought and held an asset that increased in value during the holding period, but "worked intensively ... to increase the likelihood that his qui tam suit would be successful." Finally, the court summarily dismissed the taxpayer's argument that the increase in value of the claim was a capital asset under § 1234A, on the grounds that § 1234 only applies with respect to assets that are capital assets to start with.

5. Be still open transaction doctrine! Let's fight over the proper basis apportionment method. Dorrance v. United States, 110 A.F.T.R.2d 2012-5176 (D. Ariz. 7/9/12). The taxpayers, who originally had purchased life insurance form a mutual life insurance company, received stock when the life insurance company demutualized; they retained the life insurance policies. The Form 1099-B that the taxpayers received, consistent with IRS policy, listed the basis in the stock as zero. When the taxpayers sold the stock, they reported it as having a zero basis and filed a refund claim seeking summary judgment based on the argument that the open transaction doctrine applied to the demutualization and that the basis in the life insurance policies resulting from the payment of premiums should be allocated to the stock with the result that all of the proceeds from the stock sale were a return of capital and they thus owed no tax. The government sought summary judgment on the theory that no part of the insurance premiums was paid to acquire the mutual rights under the policy, and that the entire premium was paid to purchase the policy, with the result that the stock received in exchange for the mutual rights had a zero basis. The District Court denied both motions, holding, first, that the open transaction doctrine did not apply, rejecting the Court of Federal Claims decision in *Fisher v. United States*, 82 Fed. Cl. 780 (Fed. Cl. 2008), which accepted the taxpayer's argument that the open transaction doctrine applied, allowing the taxpayer to treat all of the premium payments he had made during the course of the policy, as capital investment where the taxpayer received a cash payment in exchange for his mutual rights during the demutualization of a life insurance company. The court noted that if the taxpayer was "allowed to use the open transaction doctrine in the context of stock received during demutualization, he 'is getting a windfall, because all of the basis may be allocated to the assets that will be sold, while the asset that does not require basis has had its basis reduced.'" The court also rejected the government's position, finding that the value of both the mutual rights and the policy itself at the time of demutualization could be determined. However, neither party had presented evidence from which the court could equitably apportion the premiums paid before demutualization as basis in the mutual rights and basis in the policies themselves. The court instructed the parties to bring forward arguments for choosing between two different valuation methods: (1) compare the cost of the policies to the cost of comparable policies issued by non-mutual insurance companies at the time of issuance; or (2) comparing the market value of the policy and the stock at the time of demutualization, and applying that ratio to the premium payments.

6. Should the name of the promoter of this tax scam have been "Devious," instead of "Derivium?" Calloway v. Commissioner, 135 T.C. 26 (7/8/10) (reviewed). In 2001 the taxpayer entered into an agreement with Derivium Capital LLC pursuant to which he transferred 990 shares of IBM common stock to Derivium under its 90-percent-stock-loan program. The terms of the agreement characterized the transaction as a loan, with the IBM stock pledged as collateral. (Derivium was not registered with the New York Stock Exchange or the National Association of Securities Dealers/Financial Industry Regulatory Authority.) The purported loan was nonrecourse; interest accrued but was not payable until maturity; all dividends were applied against interest due; prepayment during the 3-year term of the purported loan was prohibited. The terms of the agreement allowed Derivium to sell the stock and retain the proceeds, which it did immediately upon receipt, receiving $103,918.18. The taxpayer received $93,586.23 from Derivium, the amount of the payment being determined, and payment being made, only after Derivium had sold the stock. Upon maturity of the 'loan," the taxpayer had the option of (1) paying the balance due and having an equivalent amount of IBM stock returned to him, (2) renewing the purported loan for an additional term, or (3) satisfying the "loan" by surrendering any right to receive IBM stock. At maturity in August 2004 the balance due was $124,429.09, which was $40,924.57 more than the then $83,318.40 value of the IBM stock. (Derivium had credited against the accrued interest the amount of dividends that would have been received had the stock not been sold, but the taxpayer never received a Form-1099-DIV or included any dividends in income.) The taxpayer elected to satisfy his purported loan by surrendering any right to receive IBM stock. The taxpayer never made any payments toward either principal or interest on the purported loan. Citing *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945), and *Gregory v. Helvering*, 293 U.S. 465 (1935), for the proposition that substance controls over form, the Tax Court, in a reviewed opinion by Judge Ruwe (with no dissents but with Judges Halpern, Wherry, and Holmes concurring in result only), held that the 2001 transaction between taxpayer and Derivium was a sale, not a loan, under the test factors set forth in *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221 (1981). The taxpayer had transferred all the benefits and burdens of ownership of the stock to Derivium. Legal and equitable title, as well as possession and control of the stock were transferred in exchange for $93,586.23 with no obligation to repay that amount. "At best [the taxpayer] had an option to purchase an equivalent number of IBM shares after 3 years at a price equivalent to $93,586.23 plus 'interest.'" The transaction was not a true loan because "[f]or a transaction to be a bona fide loan the parties must have actually intended to establish a debtor-creditor relationship at the time the funds were advanced." There was no such intent. After the 2001 transaction the taxpayer never treated the transaction as a loan; in 2004 he did not report either a sale of the stock or cancellation of debt income, positions which were inconsistent with treating the transaction as a loan. Because Derivium was not acting as a broker, the court also rejected the taxpayer's argument that the transaction was analogous to the securities lending arrangement in Rev. Rul. 57-451, 1957-2 C.B. 295, which held that no sale occurred when the owner of stock deposited shares with a broker who could lend the securities until such time as the shareholder received from the broker property other than identical securities. Nor was the transaction equivalent to a securities lending arrangement under § 1058, because the agreement did not meet the requirements of that provision, which under *Samueli v. Commissioner*, 132 T.C. 37 (2009), requires that the transferor of the stock retain "all of the benefits and burdens of ownership of the transferred securities" and the right to "be able to terminate the loan agreement upon demand." Because the taxpayer could not regain possession of the stock for three years, his opportunity for gain was diminished.

- Section 6662 accuracy related penalties were sustained.

- Judge Hapern's concurring opinion emphasized that the *Grodt & McKay* test, while appropriate for determining whether there had been a sale of property that was not fungible, was not useful in the determination of whether there had been a sale of fungible property, such as corporate stock. It was enough for him that the taxpayer "gave Derivium the right and authority to sell the IBM common stock in question for its own account, which Derivium in fact did."

- Judge Holmes's concurring opinion emphasized that the majority's test for a sale was too broad and could be applied to treat too wide a range of collateralized nonrecourse loan arrangements as sales. He concluded that the majority erred in treating the taxpayer's transfer of the stock to Derivium and Derivium's subsequent sale of the stock as one integrated transaction, because Derivium had represented to its customers that it would hold the stock and never told them of the quick sale. Instead, he would have treated Derivium's sale of the stock as the event triggering recognition by the taxpayer, under the *Tufts* principle that "when a nonrecourse liability is discharged by sale of collateral, the borrower must recognize income at that point – the amount realized is the amount of nonrecourse liability discharged as a result of the sale," since Reg. § 1.1001-2(a)(4)(i) provides that "the sale ... of property that secures a nonrecourse liability discharges the transferor from the liability." He recognized that under his analysis, "the tax consequences to Calloway would be remarkably similar to those flowing from the result reached by the majority."

• The Tax Court majority opinion noted in a footnote that other cases involving Derivium transactions are pending in the Tax Court. From 1998 to 2002 Derivium engaged in approximately 1,700 similar transactions involving approximately $1 billion. The Government estimated the total tax loss associated with Derivium's scheme to be approximately $235 million.

• *Nagy v. United States*, 104 A.F.T.R.2d 2009-7789, 2010-1 U.S.T.C. ¶ 50,177 (D. S.C. 2009), *and United States v. Cathcart*, 104 A.F.T.R.2d 2009-6625, 2009-2 U.S.T.C. ¶ 50,658 (N.D. Calif. 2009) held, in § 6700 penalty cases, that the 90-percent stock- loan-program transactions offered by Derivium were sales of securities, not bona fide loans.

• District Court had enjoined Derivium Capital USA from promoting its 90 percent loan program. United States v. Cathcart, 105 A.F.T.R.2d 2010-1293 (N.D. Calif. 3/5/10).

a. **And the Eleventh Circuit teaches even more about how to distinguish sales from loans in affirming the Tax Court.** Calloway v. Commissioner, 110 A.F.T.R.2d 2012-___ (11th Cir. 8/23/12). In an opinion by Judge Ripple, the Eleventh Circuit affirmed the Tax Court's decision, essentially following the rationale of the Tax Court's majority opinion. Like the Tax Court, the Court of Appeals considered the *Grodt & McKay* factors to determine whether there had been a transfer of the benefits and burdens of ownership, which would thereby constitute a "sale," while pointing out that "'[N]one of these factors is necessarily controlling; the incidence of ownership, rather, depends upon all the facts and circumstances,'" citing *H.J. Heinz Co. & Subsidiaries v. United States*, 76 Fed. Cl. 570, 582 (2007). The Court of Appeals also considered the somewhat overlapping factors applied by the Tax Court in *Dunne v. Commissioner*, T.C. Memo 2008-63 specifically with respect to ownership of stock:

(1) Whether the person has legal title or a contractual right to obtain legal title in the future;
(2) whether the person has the right to receive consideration from the transferee of the stock;
(3) whether the person enjoys the economic benefits and burdens of being a shareholder;
(4) whether the person has the power to control the company;
(5) whether the person has the right to attend shareholder meetings;
(6) whether the person has the ability to vote the shares;
(7) whether the stock certificates are in the person's possession or are being held in escrow for the benefit of that person;
(8) whether the corporation lists the person as a shareholder on its tax returns;
(9) whether the person lists himself as a shareholder on his individual tax return;
(10) whether the person has been compensated for the amount of income taxes due by reason of the person's shareholder status;
(11) whether the person has access to the corporate books; and
(12) whether the person shows by his overt acts that he believes he is the owner of the stock.

• Applying the *Grodt & McKay* factors, as "refined" by *Dunne*, the court concluded that the most relevant factors "firmly" established that the transaction was a sale. Notwithstanding their labels, the agreements as a whole made it clear that during the period of time covered by the "loan" Derivium owned the stock. The court looked to its precedents under which "'the characteristics typically associated with "stock" are that it grants 'the right to receive dividends contingent upon an apportionment of profits'; is negotiable; grants 'the ability to be pledged or hypothecated'; 'confer[s][ ] voting rights in proportion to the number of shares owned'; and has 'the capacity to appreciate in value.'" When the taxpayer transferred the stock to Derivium pursuant to the agreements, "he ceded these rights of stock ownership to Derivium." Other *Grodt & McKay* benefits and burdens test factors also led to the conclusion that the transaction was a sale. The agreements granted "Derivium the right to possess the stock, the equity in the stock, and the right to receive the profits from either holding

Back to Table of Contents

or disposing of the stock;" that the loan was nonrecourse assured that the risk of loss was shifted entirely to Derivium.

- The Court of Appeals rejected the approach taken by Judge Halpern in his concurring opinion, concluding that "Judge Halpern's approach risk[ed] transforming, for income tax purposes, all interests secured by stock into sales of stock." It also rejected the approach taken by Judge Holmes in his concurring opinion, concluding that "Judge Holmes's test could result in understatements of income when taxpayers have absolutely no way to determine that a taxable event has occurred."

b. Devious Derivium strikes again Raifman v. Commissioner, T.C. Memo. 2012-228 (8/7/12). The taxpayer transferred stock to Derivium under its infamous "90% Stock Loan" program. Following *Calloway v. Commissioner*, 135 T.C. 26 (2010), the Tax Court (Judge Wells) granted the IRS's motion for summary judgment that the transactions were sales and not loans, but denied the IRS's motion for summary judgment on the taxpayer's claim for a theft loss deduction, concluding that genuine issues of material fact remained regarding whether the taxpayer was entitled to a theft loss deduction for the amount of the value of the options they purchased from Derivium. The taxpayer's affidavit alleged that Derivium misrepresented the nature of the transaction because Derivium never engaged in a plausible hedging strategy, but rather appeared to be massively betting that the price of all of its clients' stocks would fall, "hedged" only by a Ponzi scheme, and that the taxpayer relied on Derivium's misrepresentations when he entered into the 90% Stock Loan program by which he was defrauded. The instant case is distinguishable from prior Derivium cases in that none of the prior cases considered the taxpayer's attempt to exercise the rights to a return of the collateral after the maturity dates.

7. This case disproves the old adage "you can't lose for trying." Sollberger v. Commissioner, 110 A.F.T.R.2d 2012-5609 (9th Cir. 8/16/12). The taxpayer entered into an agreement with Optech pursuant to which he transferred floating rate notes (FRNs) worth approximately $1 million to Optech in return for a nonrecourse loan of 90 percent of the value of the FRNs. Under the agreement Optech had the right to receive all dividends and interest on the FRNs, and the right to sell the FRNs during the loan term without Sollberger's consent. Optech did not hold the FRNs as collateral for the loan, but immediately sold the FRNs and transferred 90 percent of the proceeds to the taxpayer. The taxpayer treated the transaction as a loan rather than as a sale. The Ninth Circuit (Judge Smith) affirmed the Tax Court's holding (T.C. Memo. 2011-78) that the transaction was a sale. The court stated:

> Although the transaction took the form of a loan, Sollberger transferred the FRNs to Optech, and gave Optech the right to sell the FRNs (which Optech promptly exercised), to transfer the registration of the FRNs into its own name, and to keep all interest due from the FRNs. Sollberger would not be personally liable if he did not make payments on the loan since it was nonrecourse. Nonrecourse financing, which is sometimes viewed as an "indicator of a sham transaction," *Sacks v. Comm'r*, 69 F.3d 982, 988 (9th Cir. 1995), placed Sollberger more in the position of a seller than a debtor. Nowhere in the Master Agreement or the Loan Schedule did Sollberger promise to repay the money "lent" to him. Instead, Optech merely agreed to return the FRNs if Sollberger repaid the loan at the end of the seven-year loan term, thereby giving Sollberger the option of repurchasing the FRNs in seven years, but not requiring him to do so. Thus, the transaction was more akin to an option contract, whereunder the FRNs were sold, but the seller retained a call option to reacquire them after seven years, if he elected to do so, than a true loan. ...
>
> Sollberger's and Optech's conduct also confirms our conclusion that the transaction was, in substance, a sale. Although interest accrued on the loan, Sollberger stopped receiving account statements and making interest payments after the first quarter of 2005, less than one year into the seven-year loan term. Thus, neither Sollberger nor Optech maintained the appearance that a genuine debt existed for long. The total amount that Sollberger paid to Optech was *de*

Back to Table of Contents

> *minimis* compared to the size of the loan. The FRNs were also sold before Sollberger received the loan from Optech, which suggests that Optech funded the majority of the "loan amount" with the proceeds received from the sale of the FRNs. The apparent lack of any ability or intention by Optech to hold the FRNs as collateral to secure repayment of the loan further buttresses our conclusion that the transaction was merely a sale in the false garb of a loan.

- The court also rejected the taxpayer's argument that the transaction came within the § 1058 safe harbor for securities lending transactions because the requirements of that section clearly had not been met.

8. The Cap Gemini exchange cases:

a. Gain is recognized on an exchange even if the taxpayer didn't yet have what she got and she might not have gotten to keep it. United States v. Culp, 99 A.F.T.R.2d 2007-618 (M.D. Tenn. 12/29/06). The government was granted summary judgment in an erroneous refund suit. The taxpayer exchanged her partnership interest in Ernst & Young for stock of a corporation acquiring E&Y's consulting business, in a transaction that was not a statutory nonrecognition event; however, the stock was held in escrow to enforce a forfeiture provision if the seller-taxpayer failed to perform certain services as an employee of the acquiring corporation. The court held that the open transaction doctrine was not applicable. If a taxpayer exchanges one property for a different property, the gain realized on the exchange must be recognized in the year the exchange occurs, even though the property received in the exchange is forfeitable if contractual provisions or representations in the contract for exchange are not subsequently satisfied and even though the property received in the exchange is held in escrow to assure enforcement of the forfeitability provisions.

b. The Seventh Circuit affirmed taxable exchange treatment for an E&Y consulting partner in a Capgemini exchange. United States v. Fletcher, 562 F.3d 839 (7th Cir. 4/10/09), *aff'g* 101 A.F.T.R.2d 2008-588 (N.D. Ohio 1/15/08). In this 2000 exchange of taxpayer's partnership interest in E&Y for restricted stock of Capgemini, the Seventh Circuit (Judge Easterbrook) affirmed the summary judgment award to the government in this erroneous refund suit, and in the process "Fletcherized"[2] the E&Y consulting partner involved because she initially took the position of the parties to the transaction that all of the Capgemini shares received vested in the year 2000 [the year of the exchange], but after the stock declined in value took the position that she received income in 2000 only to the extent of cash she received in that year and the remainder of her income was recognized in 2003 [when the stock was worth less than one-fifth of its 2000 value].

- Judge Easterbrook did not appreciate the argument that she signed the "consulting partner transaction agreement" [which provided for taxable gain in 2000] only because she was afraid she would be fired if she did not do so. Both the district court and the Seventh Circuit held that under either *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967), or the alternative "strong proof" test, taxpayer was bound by the agreement she signed. he stated that:

> Fletcher argues that she didn't "really" agree to the structure that Ernst & Young and Cap Gemini (and most of her partners) wanted in 2000. If she had voted no and refused to sign, she maintains, she would have been excluded from the economic benefits and might have been fired. If this is so, then she had a difficult choice to make; it does not relieve her of the choice's consequences. Hard choices may be gut-wrenching, but they are choices nonetheless. Even naive people baffled by the fine print in contracts are held to their terms; a sophisticated business consultant who agrees to a multi-million-dollar transaction is not entitled to demand the deal's benefits while avoiding its detriments. The argument that Fletcher can avoid the terms as a matter of contract law is frivolous. All that matters now are the tax consequences of the contracts she signed.

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[2] Horace Fletcher (1849–1919), a health food faddist, argued that food should be chewed thirty-two times before being swallowed. "Nature will castigate those who don't masticate."

Back to Table of Contents

- Judge Easterbrook concluded:

> The more likely it is that the conditions will be satisfied, and all restrictions lifted, the more sensible it is to treat all of the stock as constructively received when deposited in the account. To see this, suppose that the parties had wanted to defer the recognition of income and had put $ 2.5 million in each partner's account, with the condition that the whole amount would be forfeited if the temperature in Barrow, Alaska, exceeded 80 [degrees] F on January 1, 2005. Would the remote possibility of an Arctic heat wave enable the partners to defer paying taxes? Surely not. See *Cemco Investors, LLC v. United States*, 515 F.3d 749 (7th Cir. 2008). If, on the other hand, the parties agreed that the ex-partners would receive $ 2.5 million only if the temperature in Barrow on January 1, 2005, exceeded 80 [degrees] F, then none of the partners would constructively receive income in 2000; everything would depend on events in 2005.
>
> The sort of contingencies that could lead to forfeitures were within the ex-partners' control. That implies taxability in 2000, for control is a form of constructive possession. And the agreement to discount the stock by only 5% tells us that the parties deemed forfeitures unlikely. Fletcher's acknowledgment that the risk of forfeiture was small shows that the conditions of constructive receipt in 2000 have been satisfied.
>
> Thus although we agree with Fletcher that the ex-partners are entitled to contest the tax treatment called for by the 2000 contracts, we hold that the shares are taxable in 2000 at their value on the date of deposit to the accounts at Merrill Lynch. Income was constructively received in that year not because the contract said that everyone would report it so to the IRS, but because the parties were *right* to think that this transaction's actual provisions made the income attributable to 2000. That the price of Capgemini stock dropped in 2001 and later does not entitle the parties to defer the recognition of income. Fletcher must repay the refund (and amend her returns for later years to reflect receipt of the income in 2000).

c. Ex-post recharacterization is not an option for taxpayers. United States v. Bergbauer, 602 F.3d 569 (4th Cir. 4/16/10). The Fourth Circuit affirmed a summary judgment for the government in an erroneous refund suit. The taxpayer exchanged her partnership interest in Ernst & Young for stock of Cap Gemini, a corporation acquiring E&Y's consulting business, in a transaction that was not a statutory nonrecognition event; however, the stock was held in escrow to enforce a forfeiture provision if the seller-taxpayer failed to perform certain services as an employee of the acquiring corporation. The taxpayer initially reported that all of the Cap Gemini shares received vested in the year 2000 (the year of the exchange), but after the stock declined in value took the position that income was realized in 2000 only to the extent of cash received in that year and the remainder of the income was recognized in 2003 (when the stock was worth less than one-fifth of its 2000 value). The court held that if a taxpayer exchanges one property for a different property, the gain realized on the exchange must be recognized in the year the exchange occurs, even though the property received in the exchange is forfeitable if contractual provisions or representations in the contract for exchange are not subsequently satisfied and even though the property received in the exchange is held in escrow to assure enforcement of the forfeitability provisions. Furthermore, the court refused to accept the taxpayer's argument that the transaction could be recast into a form different than that which it had taken

> To put it plainly, we have bound taxpayers to "the 'form' of their transaction" when they attempt to recharacterize an otherwise valid agreement bargained for in good faith. [citation omitted] We have also refused to entertain arguments "that the 'substance' of their transaction triggers different tax consequences." [citation omitted] This precept not only maintains the vital public

policy of enforcing otherwise valid contracts, but also assures the reliability of agreed tax consequences to the public fisc. …

There is no "disparity" in allowing "the Commissioner alone to pierce formal" agreements as "taxpayers have it within their own control to choose in the first place whatever arrangements they care to make." [citation omitted]

- Earlier cases that reached the same result for other taxpayers involved in the same transaction include *United States v. Fletcher*, 562 F.3d 839 (7th Cir. 4/10/09); *United States v. Culp*, 99 A.F.T.R.2d 2007-618, 2007-1 U.S.T.C. ¶50,399 (M.D. Tenn. 12/29/06); and *United States v. Nackel*, 105 A.F.T.R.2d 2010-474 (C.D. Cal. 10/20/09).

d. **Judge Dyk stuck his finger into the Cap Gemini pie and pulled out a constructive receipt plum.** Hartman v. United States, __ F.3d __ (Fed. Cir. 9/10/12). This Cap Gemini case was decided in favor of the government, as were all of the other Cap Gemini cases. The Federal Circuit (Judge Dyk) rejected the government's argument that taxpayer was bound under *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967), by his agreement to recognize for federal income tax purposes in the year 2000 all the shares of Cap Gemini that were placed in escrow for him in that year because *Danielson* was limited to situations where "a taxpayer challenges express allocations of monetary consideration." Instead, Judge Dyk found that taxpayer was in constructive receipt of all the Cap Gemini stock that was received for him in exchange for his E&Y partnership interest even though the stock was placed into an escrow account and he could not receive the stock until subsequent years – subject to the risk of forfeiture should he sooner voluntarily terminate his employment with Cap Gemini.

B. Interest, Dividends, and Other Current Income

1. **Quasi-substitutes for dividends ain't qualified dividends – pay up at ordinary rates.** Rodriguez v. Commissioner, 137 T.C. 174 (12/7/11). The Tax Court agreed with the IRS's conclusion in Notice 2004-70, 2004-2 C.B. 724, that amounts of a controlled foreign corporation's income that are includable by the shareholders as ordinary income under §§ 951(a)(1)(B) and 956, because the CFC's earnings and profits were invested in U.S. property, were not qualified dividend income subject to the § 1(h)(11) preferential tax rate. Because there was no distribution, and neither the Code nor the regulations provides a special rule treating a § 951 inclusion as a dividend for purposes of §1 (h)(11), there was no dividend. "[T]o say that section 951 treats a CFC's investments in U.S. property 'much like' a constructive dividend is a far cry from saying that such amounts actually constitute dividends. In fact, the statutory structure and operating rules in the Code, particularly as they have evolved over time, strongly suggest that these amounts do not constitute dividends under the Code." There are important distinctions between dividends and § 951 inclusions: (1) while dividend distributions reduce the earnings and profits of the distributing corporation, § 951 inclusions do not; and (2) while a dividend does not result in an increase to the shareholder's stock basis, a § 951 inclusion does.

2. **The statute might read "State or local bond" but it means "State or local obligation."** DeNaples v. Commissioner, 674 F.3d 172 (3d Cir. 3/19/12). The Third Circuit (Judge Fuentes) held that the § 103 exclusion for state and local bond interest applied to interest on an obligation issued by a state government that provided for deferred payments, with interest, to compensate the taxpayers for condemned land. Even though § 103 refers to "bond[s]," it applies to any "obligation" of a state that is incurred "under the borrowing power." However, it does not to apply when a government's obligation to pay interest arises by operation of law. In this case the state's obligation to pay interest arose from voluntary bargaining in which the state invoked its borrowing power.

C. Profit-Seeking Individual Deductions

1. **The IRS still can't figure out *Knight*.** Notice 2010-32, 2010-1 C.B. 594 (4/1/10). This notice provides that pending further guidance, taxpayers are not required to determine the portion of a "bundled fiduciary fee" that is subject to the § 67 two-percent of AGI floor on miscellaneous itemized deductions for any taxable year beginning before 1/1/10. Taxpayers may deduct the full amount of the bundled fiduciary fee; payments by the fiduciary to third parties for expenses subject to the two-percent floor must be treated separately. It modifies

and supersedes Notice 2008-116, 2008-1 C.B. 593, which provided similar relief for years beginning before 1/1/09.

a. But we don't have to wait until final regulations are published. Notice 2011-37, 2011-20 I.R.B. 785 (4/13/11). This notice extends the interim guidance provided in Notice 2010-32, 2010-1 C.B. 594 (4/1/10), to taxable years that begin before the date final regulations under Temp. Reg. § 1.67-4 are published.

b. Proposed regulations are published. REG-128224-06, Section 67 Limitations on Estates or Trusts, 76 F.R. 55322 (9/7/11). These proposed regulations would add Reg. § 1.67-4, to define whether some costs incurred by an estate or non-grantor trust would have been "commonly or customarily … incurred by a hypothetical individual owning the same property …." Fees for investment advice would be covered by the 2-percent floor but incremental costs of investment advice incurred because the advice is rendered to a trust or estate are not subject to the floor. Bundled fees may be allocated by "[a]ny reasonable method …."

D. Section 121

E. Section 1031

1. Judge Goeke lets the taxpayer get away with a like-kind exchange claim where the replacement property was used as taxpayer's principal residence. Reesink v. Commissioner, T.C. Memo. 2012-118 (4/23/12). The taxpayer disposed of an undivided one-half interest in an apartment building (along with his estranged brother) and acquired a single family home (the Laurel Lane property), which was originally acquired as investment or rental property, but into which the taxpayer and his family moved, as their principal residence, eight months after the acquisition. According to the Tax Court (Judge Goeke), the only issue in the case relating to whether the acquisition and disposition of the two properties qualified as a like kind-exchange was whether the taxpayer held the acquired property "with investment intent at the time of the exchange." Based on a number of factors, including the taxpayer's efforts to rent the acquired property, that he did not sell his principal residence in another city until six months after the acquisition, and the testimony of the taxpayer's estranged brother that the taxpayer did not plan to relocate until his son was finished with high-school, which he was not at the time of the transaction, Judge Goeke held that the taxpayer had acquired the property for investment.

F. Section 1033

G. Section 1035

H. Miscellaneous

IV. COMPENSATION ISSUES

A. Fringe Benefits

1. The IRS modifies guidance on reporting of employer-provided healthcare coverage despite the fact that the amounts reported have no relevance whatsoever to anyone's taxes. Notice 2012-9; 2012-4 I.R.B. 315 (1/3/12), *superseding* Notice 2011-28, 2011-16 I.R.B. 656. The IRS has issued interim guidance on informational reporting to employees of the cost of their group health insurance coverage under § 6051(a)(14). The notice includes the following statement: "This reporting to employees is for their information only. The reporting is intended to inform them of the cost of their health care coverage, and does not cause excludable employer-provided health care coverage to become taxable. Nothing in § 6051(a)(14), this notice, or the additional guidance that is contemplated under § 6051(a)(14), causes or will cause otherwise excludable employer-provided health care coverage to become taxable."

2. The IRS began ramping up for the Patient Protection and Affordable Care Act even before the Supreme Court upheld it. Notice 2012-17, 2012-9 I.R.B. 430 (2/9/12). The IRS (along with the Labor Department and Department of Health and Human Services) has issued guidance in Q-&-A format that is intended to identify likely direction and scope of future regulations and other published guidance addressing provisions of the Patient Protection and Affordable Care Act that become effective beginning in 2014. The guidance explains (1) automatic enrollment of new full-time employees where employer has more than

200 full-time employees; (2) employer shared responsibility and assessable payment; and, (3) 90-day limitation on waiting period.

3. The value of those corporate jets that some people want to tax. Rev. Rul. 2012-10, 2012-2 I.R.B. 273 (3/29/12). The IRS has announced the cents per mile and terminal charges for calculating the value of noncommercial flights on employer provided aircraft as a fringe benefit for the period January 1 through June 30, 2012. The cents per mile is multiplied by the aircraft multiple (based on size) in Reg. § 1.61-21(g)(7), then increased by the terminal charge. The mileage rates are, up to 500 miles − $0.2455 per mile, 501-1500 miles − $0.1872 per mile, and over 1500 miles − $0.1800 per mile. The terminal charge is $44.88.

4. This one hits parents of special needs children the hardest. Wouldn't it just be easier to have a government-run national health care program? Then we could have rationing by queue. Notice 2012-40, 2012-26 I.R.B. 1046 (5/31/12). This Notice provides guidance on the limits in § 125(i) on salary reduction contributions to health flexible spending arrangements, effective for cafeteria plan years beginning after 12/31/12, and requests comments on possible modification to the "use-or-lose" rule in the proposed § 125 regulations. The Notice provides that the $2,500 limit does not apply for plan years that begin before 2013 and plans may adopt the required amendments to reflect the $2,500 limit at any time through the end of calendar year 2014. (Indexing of the $2,500 limit applies to plan years beginning after 12/31/13.) For plans providing a grace period (which may be up to two months and 15 days), unused salary reduction contributions to the health FSA for plan years beginning in 2012 or later that are carried over into the grace period for that plan year will not count against the $2,500 limit for the subsequent plan year.

5. Did the Tax Court really mean to deny a deduction for a taxable fringe benefit? DKD Enterprises, Inc. v. Commissioner, T.C. Memo. 2011-29 (1/31/11). The Tax Court (Judge Chiechi) upheld the IRS's denial of the corporation's deduction of the cost of medical insurance premiums for a policy covering its employee/sole shareholder because the corporation "failed to carry its burden of establishing that it had in effect during any of the years at issue a sickness, hospitalization, medical expense, or similar benefit plan for employees." For that same reason, the individual shareholder/employee was not entitled to exclude the amount of the premiums under either § 105 or § 106.

- Notably, the court did not expressly recharacterize the premium payment as a constructive dividend.

a. And the Eighth Circuit also seems to be smoking suspicious substances in analyzing this issue. DKD Enterprises, Inc. v. Commissioner, 685 F.3d 730 (8th Cir. 8/17/12). The Eighth Circuit, in an opinion by Judge Riley, affirmed "[b]ecause the tax court permissibly found DKD failed to prove the payments were made pursuant to a pre-determined plan for the benefit of employees." Although acknowledging that under Reg. § 1.105-5, "a plan may cover a single employee or limited class of employees; need not be in writing; and need not be enforceable by the employee," the court held that there was no "plan" because while the taxpayer "testified DKD 'paid [her] quarterly medical insurance,' paying approximately the same amount for her insurance in 2003, 2004, and 2005," she "did not testify these payments were made according to a pre-determined 'plan' intended to benefit employees."

- We wonder whether the court's reasoning indicates that it thought twelve consecutive payments for medical insurance were made by accident. "Plan" versus "accident;" are there any other alternatives?

6. Premiums for corporate welfare benefit plans for principal owners fail the smell test, with penalties. Curcio v. Commissioner, 110 A.F.T.R.2d 2012-5180 (2d Cir. 8/9/12). In consolidated cases involving three different subchapter S corporations, Judge Chin upheld the Tax Court's denial of deductions for premiums paid to maintain welfare benefit plans consisting of individual life insurance policies for selected employees, the so-called Benistar 419 plan, a multi-employer welfare benefit trust. The plan allowed the policy beneficiaries to withdraw the life insurance policies from the plan and obtain the net surrender value. In each case the court found that the life insurance policies were provided to key employees (shareholders) for the personal benefit of the employees (to fund a buy/sell agreement, to provide

Back to Table of Contents

retirement planning, and to divert business profits). While the court acknowledged that contributions to a welfare benefit plan may be deductible, in these cases the court indicated that the Tax Court did not err in finding that the contributions were not helpful for the development of the taxpayers' businesses and were made instead for the personal benefit of the S corporation shareholders. The court observed that the plan was designed to benefit the owners and their families, not the respective business entities. In addition to upholding tax deficiencies representing increased pass-through income to the taxpayers, the court upheld § 6662(a) accuracy related penalties, again indicating that the Tax Court did not err in concluding that the taxpayers were negligent and acted in disregard of the tax rules and regulations. The court further rejected the taxpayer's assertion that they relied on the advice of their accountants noting that there was little reason for the taxpayers to believe that their accountants were experts in the tax treatment of welfare benefit plan contributions or that the accountants had sufficiently researched the issue.

B. Qualified Deferred Compensation Plans

C. Nonqualified Deferred Compensation, Section 83, and Stock Options

1. A sad story involving non-qualified stock options, with a different twist. McLaine v. Commissioner, 138 T.C. No. 10 (3/13/12). In this review of a CDP proceeding the Tax Court, in a reviewed opinion by Judge Colvin, sustained the IRS's determination to proceed with a levy against the taxpayer to collect unpaid taxes resulting from his exercise of non-qualified stock options. The taxpayer argued that in the CDP proceeding the IRS wrongly denied him a § 31 credit for a third-party payment by a successor to his former employer of the taxes that should have been withheld from the stock proceeds but which the taxpayer claimed were paid in the year after the year in which he filed his tax return. Judge Colvin found that there was no evidence that any such payment occurred.

- Judge Halpern (joined by Judge Holmes) concurred, but would have held that as a matter of law, even if the successor company paid the non-withheld taxes associated with the option exercise in a later year, the taxpayer would not have been entitled to a § 31(a) credit for the payment. He wrote:

> I believe the law is clear that an employer's (or former employer's) payment to the Internal Revenue Service (IRS) of taxes that should have been, but were not, withheld in a prior year does not entitle the employee to a section 31(a) credit for that payment. Under those circumstances we have a duty not to mislead taxpayers by perpetuating a case ... that may very well encourage needless litigation. Therefore, we should hold, in the alternative, that, as a matter of law, the VarTec payment alleged by petitioner, even if proven, would not entitle him to a section 31(a) credit therefor.

2. 20/20 hindsight doesn't change the value of stock purchased through stock options. Sheedy v. Commissioner, T.C. Memo. 2012-69 (3/14/12). In June 2006, the taxpayer exercised nonstatutory stock options in his employer, which six months later was bankrupt. The stock was not publicly traded but was bought and sold through an investment bank that maintained a trading desk with the ability to facilitate secondary trading among and between accredited investors and qualified institutional buyers; the investment bank did not set these prices but reported prices resulting from a bid-ask process in which it acted as the market maker. Between January 11, 2005, and February 22, 2007, the price per share ranged between $1.50 and $10.25. At the time the taxpayer exercised the options, and for several months thereafter, the investment bank sold several blocks of stock for $3 per share. The taxpayer received a W-2 showing $744,466.25 in gross income — the difference between the $750,000 fair market value of the stock (at $3 per share) on the exercise date and the $5,533.75 the taxpayer paid for the stock. Nevertheless, the taxpayer argued that the stock was worthless on the date of exercise and that he therefor realized no income. The Tax Court (Judge Laro) rejected that argument. Citing *First National Bank of Kenosha v. United States*, 763 F.2d 891, 894 (7th Cir. 1985) as controlling authority, the court held that "subsequent events should not be used to determine fair market value, except to the extent that they were reasonably foreseeable on the valuation date."

On the record, the bankruptcy and the worthlessness of the stock were not reasonably foreseeable events on the exercise date. Following the principle that "price of stock in a liquid market is presumptively the one to use in judicial proceedings," the court accepted the IRS's valuation of $3 per share. The taxpayer was required to include $744,466.25 in gross income — the difference between the $750,000 fair market value of the stock on the exercise date and the $5,533.75 that he paid for the stock.

3. **Tightening the meaning of "substantial risk of forfeiture."** REG–141075–09, Property Transferred in Connection With the Performance of Services Under Section 83, 77 F.R. 31783 (5/30/12). The Treasury Department has proposed amendments to Reg. § 1.83-3 to clarify the meaning of "substantial risk of forfeiture." Under the proposed amendments, a substantial risk of forfeiture may be established only through a service condition or a condition related to the purpose of the transfer. When determining whether a substantial risk of forfeiture exists based on a condition related to the purpose of the transfer, both the likelihood that the forfeiture event will occur and the likelihood that the forfeiture will be enforced must be considered. In addition, the proposed amendments clarify that except as specifically provided in § 83(c)(3) and Reg. § 1.83–3(j) and (k), transfer restrictions do not create a substantial risk of forfeiture, including transfer restrictions which carry the potential for forfeiture or disgorgement of some or all of the property, or other penalties, if the restriction is violated. The proposed amendments would add two additional examples to Reg. § 1.83–3(c)(4) illustrating that a substantial risk of forfeiture is not created solely as a result of potential liability under Rule 10b–5 of the Securities Exchange Act of 1934 or a lock-up agreement. (This change incorporates the holding of Rev. Rul. 2005-48, 2005-2 C.B. 259, holding that if an employee exercises a nonstatutory option more than six months after grant, and thus outside the period covered by § 16 of the Securities Exchange Act of 1934, but is subject to restrictions on his ability to sell the stock obtained through exercise of the option under Rule 10b-5 under the Securities Exchange Act of 1934 and "lock-up" contractual provisions imposed by the employer in connection with a public offering, the employee is required to recognize income under § 83 at the time of the exercise of the option because full enjoyment of the shares is not conditioned on any obligation to provide future services.)

- The proposed amendments are proposed to apply to property transferred on or after 1/1/13. Taxpayers may rely on the proposed regulations for property transferred after 5/30/12.

4. **The IRS provides help to avoid messing up your § 83(b) election, but you still have to remember to file it on time.** Rev. Proc. 2012-29, 2012-28 I.R.B. 49 (6/27/12). This Revenue Procedure provide sample language that may be used, but is not required to be used, for making a § 83(b) election. It also provides several examples of the consequences of making a § 83(b) election.

D. Individual Retirement Accounts

1. **The "use a C corporation to increase IRA contributions" scam is struck down.** Repetto v. Commissioner, T.C. Memo. 2012-168 (6/14/12). The Tax Court (Judge Marvel) imposed the 6 percent excess contribution tax under § 4973 for a scheme established by the taxpayers' CPA. The taxpayers formed two corporations, most of the stock of which was held by the taxpayers' newly formed IRAs. One of the two corporations was intended to provide office and support services, and the other to provide marketing and business development services to the taxpayers' construction and rental property businesses operated through an S corporation and LLC. The court indicated that the preponderance of the evidence supported a finding that the service agreements and the payments to the Roth IRA owned corporations "were nothing more than a mechanism for transferring value to the IRA." The court stated that the service agreements did not change the identity of the person providing services to the construction businesses, the taxpayers continued to do the work as they had done before the arrangement was structured, and the taxpayers provided no written documentation of the services provided. The court's conclusion was bolstered by the language of the engagement letter with the CPA, which supported the finding that payment of dividends to the Roth IRAs was the primary

goal of the support agreements. The court determined that the amount contributed to the Roth IRA and the amount of excess contributions should be determined based on the fair market value of the Roth IRA at year end. The court rejected the IRS approach that would have treated payments to the corporations as distributions to the taxpayers who subsequently contributed the amounts to the Roth IRAs.

- In the consolidated cases the court also held that amounts distributed by the taxpayers' S corporation were to be treated as wages rather than distributions.
- Amounts paid for medical plans that benefited the taxpayers by the IRA-owned C corporations were disallowed as deductions by the corporations because the employment relationship with Mrs. Repetto was a sham.
- The taxpayers were liable for a 5 percent penalty for failure to file Form 5329 reporting excess contributions to their IRAs and that the taxpayers' reliance on the tax professionals who promoted the scheme was not reasonable.
- The taxpayers were liable for the 20 percent penalty of § 6662A incurred for an understatement attributable to a reportable transaction. The transaction was substantially similar to the listed transaction described in Notice 2004-8, 2007-1 C.B. 333, promulgated before the taxpayers filed returns involving the transaction. In addition, the taxpayers were held liable for the increased 30 percent penalty of § 6662A(c) for failing to file a disclosure of their participation in a listed transaction. Again the court found that taxpayers did not reasonably rely on the advice of independent tax professionals.
- The court revised the IRS computation of the understatement subject to penalties by holding that understatements attributable to wages paid by the taxpayers' S corporation and the disallowance of medical expense deductions were not related to the listed transaction.

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

1. DOMA could be on its way to the Supreme Court. On the other hand, might this case lead to DOMA becoming the Twenty-Eighth Amendment? Not likely, unless it was left to the bigoted voters. Massachusetts v. United States Dept. of Health and Human Services, 682 F.3d 1 (1st Cir. 5/31/12), *aff'g* Gill v. Office of Personnel Management, 699 F. Supp. 2d 374 (D. Mass. 7/8/10). In an opinion by Judge Boudin, the First Circuit held that § 3 of the Defense of Marriage Act, 1 U.S.C. § 7, which limits the meaning of the word "marriage" to "a legal union between one man and one woman as husband and wife," and provides that "the word 'spouse' refers only to a person of the opposite sex who is a husband or wife" for purposes of all federal laws is an unconstitutional denial of equal protection in violation the equal protection principles embodied in the Due Process Clause of the Fifth Amendment. Joint return filing status under the Code was one of the issues addressed in the case, as well as government benefits available to married individuals, e.g., employee health benefits, social security benefits. The court further ordered:

> Anticipating that certiorari will be sought and that Supreme Court review of DOMA is highly likely, the mandate is stayed, maintaining the district court's stay of its injunctive judgment, pending further order of this court.

B. Miscellaneous Income

1. Qui tam relator's award is a taxable "reward." Campbell v. Commissioner, 658 F.3d 1255 (11th Cir. 9/28/11), *aff'g* 134 T.C. 20 (1/21/10). The taxpayer recovered a gross award of $8.75 million as a relator in a qui tam action on behalf of the United States government against a military contractor and paid $3.5 million of attorney's fees, which amount was retained by the taxpayer's attorney to whom the $8.75 million had been remitted; the taxpayer received only $5.25 million from his attorney. The Eleventh Circuit affirmed the Tax Court's decision (Judge Wells) holding that the entire gross award of $8.75 million was includable in gross income, and the $3.5 million of attorney's fees was deductible as a miscellaneous itemized deduction. The Court of Appeals reasoned that the $8.75 million was in the nature of a "reward." The Court of Appeals also upheld the § 6662(b) substantial

Back to Table of Contents

understatement penalty; even though the taxpayer filed a Form 8275, there was neither reasonable cause nor substantial authority supporting the omission from gross income.

- "Qui tam" is an abbreviation of the Latin phrase "qui tam pro domino rege quam pro se ipso in hac parte sequitor," which means "who pursues this action on our Lord the King's behalf as well as his own."

- The tax year involved in this case (2003) pre-dates the effective date of 2004 amendments to § 62(a), which now permits attorney's fees in a False Claims Act case to be an above-the-line deduction.

2. **The Treasury Department uses regulations to reverse a principle established in a Supreme Court decision that the government won. Do *Mayo* doubters think that the Treasury exceeds its powers when it issues regulations giving away government victories in the Supreme Court?** T.D. 9573, Damages Received on Account of Personal Physical Injuries or Physical Sickness, 77 F.R. 3106 (1/23/12). The Treasury Department has finalized proposed amendments (REG-127270-06, Damages Received on Account of Personal Physical Injuries or Physical Sickness, 74 F.R. 47152 (9/15/09)) to Reg. § 1.104-1(c) under § 104(a)(2) to reflect amendments to § 104 and certain judicial decisions. The amended regulations provide that the § 104(a)(2) exclusion applies to personal physical injuries or physical sickness. Emotional distress is not considered to be a physical injury or physical sickness. However, the regulations provide that damages for emotional distress attributable to a physical injury or physical sickness are excludable under § 104(a)(2). The regulations do not address loss of consortium or emotional distress from witnessing physical injury to another person. Under the amended regulations, the term "damages" means an amount received (other than workers' compensation) through prosecution of a legal suit or action, or through a settlement agreement entered into in lieu of prosecution. Notably, the amended regulations eliminate the requirement in the prior regulations that to be excludable under § 104(a)(2) the damages must have been "based upon tort or tort type rights." Thus, damages for physical injuries may qualify for exclusion under § 104(a)(2) even though the injury giving rise to the damages is not defined as a tort under state or common law. The reason for the change was the Treasury Department's concern that the Supreme Court's interpretation of the tort type rights test in *United States v. Burke*, 504 U.S. 229 (1992), limiting the § 104(a)(2) exclusion to damages for personal injuries for which the full range of tort-type remedies is available, could preclude an exclusion under § 104(a)(2) for redress of physical personal injuries under a "no-fault" statute that does not provide traditional tort-type remedies.

- Taxpayers may apply the amended regulations to amounts paid pursuant to a written binding agreement, court decree, or mediation award entered into or issued after 9/13/95 and received after 8/20/96.

3. **Compensation to victims of human trafficking is tax-free. The IRS would have been pilloried if it had ruled the other way.** Notice 2012-12, 2012-6 I.R.B. 365 (1/19/12). Mandatory restitution payments awarded under 18 U.S.C. § 1593, which criminalizes (1) holding a person to a condition of peonage; (2) kidnapping or carrying away a person to sell the person into involuntary servitude or to be held as a slave, (3) providing or obtaining a person's services or labor by actual or threatened use of certain means including force, physical restraint, serious harm, and abuse of legal process, and (4) sex trafficking of children or by force, fraud, or coercion, are excluded from gross income.

4. **It pays really big tax benefits to run your own church and give yourself two parsonage allowances.** <u>Driscoll v. Commissioner</u>, 135 T.C. 557 (12/14/10) (reviewed, 7-6). The taxpayer (Phillip Driscoll) received a parsonage allowance from Mighty Horn Ministries, Inc., later known as Phil Driscoll Ministries, Inc., that was applied to the acquisition and maintenance of not only a principal residence but also a second home — a vacation residence. The IRS disallowed a § 107 exclusion for the portion of the parsonage allowance received with respect to the second home — for four years amounts totaled over $400,000 — on the grounds that § 107(a) refers to "a home" and that the legislative history limited the§ 107 exclusion to only one home. The Tax Court majority, in an opinion by Judge Chiechi (in which four judges joined), with four concurrences, rejected the IRS's argument,

stating "[w]e find nothing in section 107, its legislative history, or the regulations under section 107, which, as respondent points out, all use the phrase 'a home,' that allows, let alone requires, respondent, or us, to rewrite that phrase in section 107." The opinion pointed to § 7701(p)(1) [(m)(1) for the years at issue)], which refers to the definition in 1 U.S.C. § 1 that provides that in interpreting the United States Code, the singular includes the plural, unless the context indicates otherwise.

- Judge Gustafson, joined by five other judges, dissented, on the grounds that exclusions should be interpreted narrowly, and "[T]he chance that Congress in 1954 thought it was permitting the exclusion of multiple parsonage allowances seems remote."

a. **Reversed and remanded. A home means only one home.** Commissioner v. Driscoll, 109 A.F.T.R.2d 2012-832 (11th Cir. 2/8/12). In a *per curiam* opinion, the Eleventh Circuit held that the rental allowance taxpayers received for their second house was not excluded from income under § 107(2) because the proposition that singular terms also include their plural terms, contained in the Dictionary Act, 1 U.S.C. 1, does not apply if "'the context indicates otherwise'" and the use of "home" in § 107(2) "has decidedly singular connotations."

5. **"Home" means where the taxpayer actually resides, not just any old house the taxpayer owns.** Stromme v. Commissioner, 138 T.C. No. 9 (3/13/12). Section 131 provides an exclusion for certain amounts paid by a state or local government (or a "qualified foster care placement agency") to a "foster care provider for caring for a qualified foster individual in the foster care provider's home," or which is a "difficulty of care payment." The taxpayers cared for several developmentally disabled adults at a home they owned and in which they worked, but in which they did not reside and received several hundred thousand dollars from the local government. The Tax Court (Judge Colvin) held that § 131 did not apply to exclude payments from the local government to provide foster care, because § 131 applies only if the care is provided in the home in which the taxpayer actually resides.

6. **Who ever heard of a local real property tax appraisal that was anywhere near accurate?** Shepherd v. Commissioner, T.C. Memo. 2012-212 (7/24/12). The taxpayers compromised a consumer credit card debt for $4,412 less than the balance and claimed that pursuant to § 108(a)(1)(B) none of the COD income should be recognized because they were insolvent. The IRS and taxpayers agreed on the amount of the taxpayers' debts and the value of all of their property with three exceptions: (1) the value of their principal residence, (2) the value of a beach house, and (3) whether a pension was an asset to be included in the determination of insolvency. The Tax Court (Judge Ruwe) held that taxpayers were not able to demonstrate insolvency because they failed to establish the value of the residences. Local tax assessments introduced by the taxpayers were insufficient evidence of value because "a value placed upon property for local taxation purposes is not determinative of fair market value of the property for Federal income tax purposes in the absence of evidence of the method used in arriving at that valuation." Appraisals introduced in to evidence were based on "comparable" sales more than two years after the date of discharge, and thus were not probative of the value of the homes at the time of the debt cancellation. The portion of the pension that could have been withdrawn, but not the excess there over, was included in the value of assets, because "the word 'assets' as used in the definition of the term 'insolvent' for section 108(d)(3) includes 'assets exempt from the claims of creditors under applicable State law'" citing *Carlson v. Commissioner*, 116 T.C. 87, 105 (2001). The taxpayers were not insolvent, and the COD income was includible in income.

7. **If you take the Fifth in front of a Senate investigating committee, you may become a martyr, but if you take the Fifth in front of the Tax Court, you lose. A Cicero, Illinois politician fraudulently underreported income by omitting conversion of $350,000 campaign funds to personal use, but that's small potatoes compared to the more than $10 million insurance fraud scheme for which she spent time in the federal slammer. There may well be a falcon mixed up in here as well, but no sign of it appears in the Tax Court opinion.** Loren-Maltese v. Commissioner, T.C. Memo. 2012-214 (7/30/12). The taxpayer, Betty Loren-Maltese, was the President of Cicero, Illinois — "a suburb of Chicago that sits on its western hip like a well-holstered gun, and that has a colorful history that reaches back into the

1920s when Al Capone took refuge there" — and the Republican Committeeman of Cicero Township in 1994. She also served as Cicero's deputy liquor commissioner, a position to which she was appointed by her husband, a "prominent Cicero politician who confessed to being a mob bookmaker and pleaded guilty to a federal gambling charge," when the previous deputy liquor commissioner resigned during an FBI investigation into his practice of taking bribes and skimming money off liquor-license renewal fees. In 2002, Loren-Maltese was convicted of conspiracy to defraud Cicero through a pattern of racketeering via multiple acts of bribery, money laundering, mail and wire fraud, official misconduct, and interstate transportation of stolen property. The conviction ended her political career, and she was sentenced to eight years in prison. The government tried her separately on criminal tax fraud charges, but the trial ended in a hung jury, and the government decided not to try her again. In the instant case, the IRS asserted a deficiency for unreported income and civil fraud penalties based on Loren-Maltese's purchase of a 1993 classic black Cadillac Allante convertible for her personal use and her investment in a luxury golf course and clubhouse with checks totaling more than $350,000 drawn on her "Committeeman Fund" account. (For the year in question, Illinois law allowed public officials, who like Ms. Loren-Maltese, were also political-party officials, to raise money from donors in their capacity as party officials, in amounts that they could keep secret. The evidence established that Cicero's town attorney explained to Loren-Maltese that she could supplement her salary by taking money from the Committeeman Fund to buy something for herself or to make an investment for her own personal benefit, but the money would be personal income to her and she would owe tax on it in the year that she took it.) The Tax Court (Judge Holmes) found that both items should have been included in Loren-Maltese's income and that her failure to do so was due to fraud. Importantly, Ms. Loren-Maltese was mostly silent during her trial, relying on her attorney's advice to take shelter under the Fifth Amendment. Judge Holmes found that Loren-Maltese's valid invocation of the Fifth Amendment nevertheless allowed the court to draw a negative inference from her refusal to answer question where the IRS produced some additional supporting evidence. Similarly, he drew inferences from Loren-Maltese's silence where, under the circumstances, it would have been natural for her to object.

C. Hobby Losses and § 280A Home Office and Vacation Homes

1. This space cadet didn't get a secret decoder ring. He might have succeeded had he had limited himself to saying "to the Moon!" Barker v. Commissioner, T.C. Memo. 2012-77 (3/20/12). The Tax Court (Judge Goeke) sustained the IRS's disallowance of deductions claimed by the taxpayer, an experienced NASA scientist, relating to planning the exploration of Mars, including "ways to actually live off the land once people have arrived on Mars as opposed to taking all supplies along on the flight." Judge Goeke held that the taxpayer was not engaged in an active trade or business because under the factors in Reg. § 1.183-2(b), the taxpayer did not conduct his activities with the intention of earning a profit. Furthermore, his nascent business had not yet begun to function as a going concern; at most he was merely researching or investigating a potential business, which is insufficient to demonstrate that a taxpayer is engaged in a trade or business.

2. Only a doctor could think he could win this case. Verrett v. Commissioner, T.C. Memo. 2012-223 (8/2/12). The taxpayer was a physician who had an annual salary as such of approximately $120,000 in each of the three years at issue. He claimed losses from a construction business run from his home for which he had no license and had never showed a profit in 17 years. Most of his services during the years at issue involved uncompensated projects for his family and his church. Obviously, the losses were disallowed under § 183.

D. Deductions and Credits for Personal Expenses

1. The IRS tries to defy national middle-income income housing policy and be too stingy with the first time homebuyer credit and, as a result, gets slapped down by the Tax Court. Woods v. Commissioner, 137 T.C. 159 (10/27/11). The taxpayer entered into a contract for deed to purchase a house in 2008, took possession of the house in 2008, and claimed the § 36 first-time homebuyer credit for 2008. The house required renovations before being ready for occupancy, and the taxpayer intended to use the credit proceeds to pay for the necessary renovations. He received a refund for the credit in 2009 and began renovations. The IRS subsequently denied the credit on the grounds that the taxpayer was not entitled to the credit because (1) the taxpayer took possession of the house under a contract for deed and therefore had not "purchased" the house, and (2) even if the "purchase" requirement was satisfied the house was not the taxpayer's "principal residence" in 2008 for purposes of § 36. The Tax Court (Judge Haines) held for the taxpayer (who represented himself pro se). First, under state (Texas) property law, the contract for deed conferred equitable title to the house on the taxpayer, and therefore he had "purchased" the house. Second § 36 requires a prospective analysis, asking whether a taxpayer will occupy a house as a principal residence. Because the taxpayer established that he intended to occupy the house as his principal residence as soon as the necessary renovations were complete, he was entitled to the first-time homebuyer tax credit for 2008.

2. **Only in the IRC can "first-time" mean not within the past three years, but these taxpayers still weren't "property virgins."** Foster v. Commissioner, 138 T.C. 51 (1/30/12). The taxpayers bought a home on July 28, 2009 and claimed the temporary, then-in-effect § 36 first-time homebuyer credit. They had listed their previously-owned house for sale in February 2006 and spent "considerable time" at one of their parents' house; the taxpayers sold their old house on June 6, 2007 and rented an apartment that month. The Tax Court (Judge Foley held that the taxpayers did not qualify for the credit. Under § 36(c)(1), a "first-time homebuyer" is any individual who has not owned a principal residence for three years prior to the date of purchase of a new principal residence. Thus, the taxpayer's could have qualified if they had not owned a principal residence after July 27, 2006, and before July 28, 2009 (i.e., the period three years prior to the purchase of their new house). Although the taxpayers owned the old house until June 6, 2007, they argued that they ceased using it as their principal residence in February 2006. Judge Foley found that the taxpayers' original home remained their principal residence through at least July, 2006 – a date within the three years preceding the purchase of the new home – because until it is was sold the original home was fully furnished, and taxpayers maintained utility services, frequently stayed overnight, hosted family holiday gatherings, kept personal belongings, accessed the Internet, and received bills and correspondence at that home, as well as listing it as the address for renewing a driver's license and filing federal income tax returns.

3. **Two unmarried male cohabitants holding residences in joint ownership were not entitled to double the § 163(h)(3) limits, but were instead restricted to mortgage interest deductions on only $1.1 million of loans.** Sophy v. Commissioner, 138 T.C. No. 8 (3/5/12). The Tax Court (Judge Cohen) decided that the $1.1 million § 163(h)(3) limitations on qualified residence indebtedness should be applied on both a per taxpayer and a per-residence basis with respect to residence owners who are not married to each other, rather than solely on the per-taxpayer basis argued for by the unmarried taxpayers who jointly owned the residence in question on which the purchase money mortgage exceeded $1.1 million. The decision was based upon congressional intent, as shown by the statute's repeated use of phrases "with respect to any qualified residence" and "with respect to such residence," which would have been superfluous had Congress intended that the limitations be applied on a per-taxpayer basis.

4. **Married filing separately status can put a big dent in the home mortgage interest deduction**. Bronstein v. Commissioner, 138 T.C. No. 21 (5/17/12). The taxpayer, who was married, purchased a residence as joint tenants with rights of survivorship together with her father-in-law. The taxpayer and her husband resided in the home, and her father-in-law did not. The amount of the mortgage exceeded $1.3 million, and the taxpayer made all of the payments on the mortgage. The taxpayer, who filed separately, deducted interest on $1.1 million of the mortgage. The Tax Court (Judge Goeke) applied § 163(h)(3)(B)(ii), which provides that a married individual filing a separate return is limited to a deduction for interest paid on $500,000 of home acquisition indebtedness, and § 163(h)(3)(C)(ii), which provides that a married individual filing a separate return is limited to a deduction for interest paid on $50,000 of home equity indebtedness, which limits the taxpayer's total deduction to interest on $550,000

of mortgage debt. Section 6662 accuracy related penalties were upheld, even though the taxpayer claimed to have relied on her tax advisor in taking her return position, because "she ... made no attempt to establish that the reliance was reasonable."

- Interestingly, the same tax advisor who prepared her return also represented her in the Tax Court litigation.

5. No dependency or child credits for nonresident, noncitizen children. Carlebach v. Commissioner, 139 T.C. No. 1 (7/19/12). This case involved whether the taxpayers were allowed § 151 dependency exemption deductions and § 21 and § 24 child-related credits, which require that the children satisfy the same statutory test, for non-resident, non-citizen children. One of the married taxpayers was a U.S. citizen and the other an Israeli, and they lived in Israel; the children were born in, and lived in Israel. The Tax Court (Judge Halpern) applied § 152(b)(3)(A), which provides that "[t]he term 'dependent' does not include an individual who is not a citizen or national of the United States unless such individual is a resident of the United States or a country contiguous to the United States," and Reg. § 1.152-2(a)(1), which provides that "to qualify as a dependent an individual must be a citizen or resident of the United States ... at some time during the calendar year in which the taxable year of the taxpayer begins" to deny the deductions and credits. He rejected the taxpayers' argument that because the children were citizens in the year (2007) in which returns were filed, they qualified as dependents for the years at issue (2004 through 2006). He also rejected the taxpayers' argument that the children had "derivative citizenship" under 8 U.S.C. § 1433, because such citizenship is not automatic, but requires an application and naturalization, which had not occurred during the years in question. Finally, he rejected the taxpayers argument that because § 152(b)(3)(A) does not require citizenship during the year in question, Reg. § 1.152-2(a)(1), which does require citizenship during the year in question, was invalid. The regulation was a reasonable interpretation of § 152(b)(3)(A), which he interpreted "in the context of subtitle A of the Internal Revenue Code, which deals with income taxes, and in which the concept of an annual accounting system is deeply embedded." Section 6662 accuracy related penalties were upheld.

6. An incomplete effort to collect on a homeowner's insurance policy is all that's necessary to secure a casualty loss deduction. Ambrose v. United States, 110 A.F.T.R.2d 2012-5564 (Fed. Cl. 8/3/12). The taxpayers' home was destroyed in a fire, and the next day they filed a timely claim with their homeowner's insurance company. However, they failed to file a timely "proof of claim" as required by the insurance policy; they sued the insurance company in state court and lost. The IRS applied § 165(h)(5)(E) to deny the taxpayer's claim for a casualty loss deduction. Section 165(h)(5)(E) provides that "[a]ny loss of an individual described in subsection (c)(3) to the extent covered by insurance shall be taken into account under this section only if the individual files a timely insurance claim with respect to such loss." The Court of Federal Claims (Judge Allegra) upheld the taxpayers' refund claim, allowing the casualty loss deduction, on the ground that § 165(h)(5)(E) does not apply to taxpayer who files a timely claim but whose claim is rejected by the insurance company when the taxpayer fails to timely file a "proof of loss" as required by the insurance policy. Reading from Webster's Dictionary to divine the meaning of the terms "file" and "claim" in § 165(h)(5)(E), Judge Alegra concluded that there is a "distinction between the filing of a claim, i.e. the 'deliver[y] ... to the proper officer' of a 'demand for something due or believed to be due' and the subsequent submission of proof of the validity of that claim," and that in enacting § 165(h)(5)(E), Congress intended to require only the former. He rejected the government's argument that "an insurance 'claim' [includes fulfilling] all of the conditions on recovery found in a given policy."

E. Divorce Tax Issues

1. The test for whether it's "alimony" is objective, not subjective. Rood v. Commissioner, T.C. Memo. 2012-122 (4/25/12). The taxpayer was obligated under Florida law to pay his former spouse a "lump sum alimony" award of $300,000 payable over 60 months in $5,000 payments. The Tax Court (Judge Goeke) held that the payments were not deductible as "alimony" because under Florida law the taxpayer's obligation did not terminate upon his former

Back to Table of Contents

wife's death. The court declined to consider extrinsic evidence in determining the nature of the payments: "The intent of the parties is irrelevant in determining whether such an obligation would terminate at death." Even though the purpose of the requirement of § 71(d)(1)(D) that the payment terminate upon death is to prevent deductions of amounts that are attributable to support of the payee, the relevant inquiry is entirely objective; the intent of the parties regarding the purpose of the payments is irrelevant.

2. A QDRO can't lend tax-free disability payment status to a substitute payee. Fernandez v. Commissioner, 138 T.C. No. 20 (5/14/12). The Tax Court (Judge Wherry) held that § 104(a)(1) does not apply to exclude disability payments paid to the disabled worker's former spouse pursuant to a § 414(p) qualified domestic relations order (QDRO).

> Section 402(a) provides that amounts distributed from employee trusts are taxable to the distributee "Except as otherwise provided in this section", and section 72 provides that "Except as otherwise provided in this chapter gross income includes any amount received as an annuity *** under an *** endowment, or life insurance contract." Nowhere in section 402(a) or section 72 is section 104(a) mentioned. Section 402(e)(1)(A) explicitly provides: "For purposes of subsection (a) [of section 402] and section 72, an alternate payee who is the spouse or former spouse of the participant shall be treated as the distributee of any distribution or payment made to the alternate payee under a qualified domestic relations order ". If Congress had included section 104 in this portion of the statute, the result in this case might be different. However, without congressional approval we decline to expand the reach of section 402(e)(1)(A) beyond the sections specifically referred to in its text.

F. Education

G. Alternative Minimum Tax

VI. CORPORATIONS

A. Entity and Formation

B. Distributions and Redemptions

1. The cat's out of the bag! DKD Enterprises, Inc. v. Commissioner, 685 F.3d 730 (8th Cir. 8/17/12), *aff'g* T.C. Memo. 2011-29 (1/31/11). The Eighth Circuit, in an opinion by Judge Riley, held that expenses incurred by a corporation to operate a cattery, the deductions for which were disallowed because the cattery was not operated with a genuine profit-seeking motive, constituted constructive dividends to the corporation's sole shareholder because the corporation operated the cattery "for the personal pleasure of ... its sole stockholder, and that during each of those years that activity was incident to [her] personal hobby." Because the corporation did not have "a legitimate business purpose to operate the cattery." the expenditures to operate constituted a constructive dividend "even though this activity conferred no tangible economic benefit on [the shareholder."

C. Liquidations

D. S Corporations

1. Poison pill warrants issued in an S corporation tax shelter scheme turn truly poisonous to S corporation status. Santa Clara Valley Housing Group, Inc. v. United States, 108 A.F.T.R.2d 2011-6361 (N.D. Cal. 9/21/11). The stock of Santa Clara Valley Housing Group, Inc. (SCVHG) originally was held by a husband and wife and their children. To implement a KPMG tax shelter product known as the S Corporation Charitable Contribution strategy (SC2), SCVHG recapitalized itself so as to have 100 shares of voting stock and 900 shares of nonvoting stock. SCVHG also issued to each shareholder a warrant to purchase ten shares of nonvoting stock for each share of voting stock (which was tax-free under § 305(a)). The warrants were issued solely to protect the original shareholders' interest in SCVHG while they engaged in the SC2 strategy. (The warrants protected against the possibility that the donee charity would refuse to sell its stock back to the original shareholders after the agreed-upon length of time, because if the warrants were exercised, the warrants would dilute the stock held by the charity to such an extent that the original shareholders would end up owning approximately 90 percent of the outstanding shares.) Thereafter, the shareholders transferred all of the nonvoting stock to stock to the City of Los Angeles Safety Members Pension Plan (CLASMPP), a tax-exempt entity as a "donation," with the understanding that CLASMPP would sell the shares back after a certain period of time. While CLASMPP held the stock, SCVHG reported over $114 million of income, of which more than $100 million was passed through to CLASMPP, but CLASMPP received distributions of only $202,500, representing .02 percent of the income allocated to CLASMPP. After four years, CLASMPP sold the 900 shares of stock back to the original shareholders for $1,645,002, and the warrants were cancelled. The IRS concluded that the transaction was an abusive tax shelter. The IRS concluded that under Reg. § 1.1361-1(*l*)(4)(ii) the warrants constituted a second class of stock in SCVHG and SCVHG's status as an S corporation was terminated and issued a deficiency notice based upon treating SCVHG as a C corporation. The District Court agreed with the IRS. The warrants "constitute equity," and were intended to prevent CLASMPP "from enjoying the rights of distribution or liquidation that ordinarily would come with ownership of the majority of a successful company's shares." Thus the warrants were a second class stock and SCVHG's S corporation status was terminated. However, the warrants were not a second class of stock under Reg. § 1.1361-1(*l*)(4)(iii), which provides that options are a second class if, under the facts and circumstances, (1) the option is substantially certain to be exercised and (2) has an exercise price substantially below the fair market value of the underlying stock on the date the option is issued. In this case it was never intended that the options be exercised; they were a "poison pill."

a. Reconsidered. Santa Clara Valley Housing Group, Inc. v. United States, 109 A.F.T.R.2d 2012-554 (N.D. Cal. 1/18/12). On reconsideration of its summary judgment, the court determined that there is a triable issue of fact whether the warrants are protected from being treated as a second class of stock under the safe harbor of Reg. § 1.1361-1(f)(4)(iii)(C), which provides that a call option will not be treated as a second class of stock if the strike price is at least 90 percent of the fair market value of the underlying stock on the date the option is issued, transferred to an ineligible shareholder, or materially modified. The regulation also directs that a good faith determination of value will be respected unless it can be shown that the valuation was substantially in error and the determination was not made with reasonable diligence. The court indicated that there is conflicting evidence regarding the value of the stock at the time the warrants were issued.

2. QSub status is a property right of the QSub. In re The Majestic Star Casino, LLC, 109 A.F.T.R.2d 2012-698 (Bankr. D. Del. 1/24/12). A debtor QSub, but not its parent S corporation, was in bankruptcy. The court held that the parent corporation's post-bankruptcy petition revocation of its S corporation status, which under § 1361(b)(3)(C) automatically terminated the debtor-subsidiary's QSub status, converting it into a C corporation, was an avoidable transfer of estate property in violation of Bankruptcy Code § 549. The debtor's QSub status was property of the bankruptcy estate, and as a result of the loss of that status was required to, and did, pay state income taxes it would not otherwise have been required to pay. (The corporation had not paid any federal income taxes, but the IRS's claim for any deficiency would be affected, so the IRS opposed the debtor's argument that its QSub status was property of the bankruptcy estate.) Accordingly, the revocation of the parent's status as an S corporation and the termination of the debtor's status as a QSub were held to be "void and of no effect."

3. Roth IRA is not an eligible S corporation shareholder. Taproot Administrative Services, Inc. v. Commissioner, 133 T.C. 202 (9/29/09) (reviewed, 12-4). The taxpayer corporation's sole shareholder was a custodial Roth IRA account. Eligible S corporation shareholders as defined in § 1361 include individuals, estates, certain specifically designated trusts and certain exempt organizations. With an effective date after the year involved in this case, § 1361(c)(2)(A)(iv) was enacted to allow a bank whose stock is held by an IRA or Roth IRA to elect S corporation status. Reg. § 1.1361-1(e)(1) provides that a person for whom S corporation stock is held by a nominee, guardian, custodian or agent is deemed to be the S corporation shareholder. However, in Rev. Rul. 92-73, 1992-2 C.B. 224, the IRS ruled that a trust that qualifies as an IRA is not a permitted S corporation shareholder. Declaring the issue as one of first impression, and indicating that under *Skidmore* deference to revenue rulings depends upon their persuasiveness, the Tax Court (Judge Wherry) agreed with the IRS's rationale in the ruling that IRAs are not eligible S corporation shareholders because the beneficiary of the IRA is not taxed currently on the trust's share of corporate income unlike the beneficiary of a custodial account or the grantor of a grantor trust who is subject to tax on the pass-through corporate income. (The income of the corporation owned by a Roth IRA would never be subject to tax.)

- Judge Holmes dissented in a beautifully-reasoned opinion which made the point that an IRA account is owned by a custodian for the benefit of an individual, who is to be treated as the shareholder, and any unwarranted tax benefits would not accrue because the income of the IRA would be taxed under § 511 as UBIT. His opinion concluded:

> This case is a reminder that tax law does not cascade into the real world through a single channel. It meanders instead through a vast delta, and any general principles tugged along by its current are just as likely to sink in the braided and re-braided rivulets of specific Code provisions and the murk of regulations as they are to survive and be useful in deciding real cases. Taproot thinks it found a course through the confluence of the subchapter S and IRA rules that it could successfully navigate. Its route would be new, but the stakes are not that great, and the sky will remain standing if we had just read and applied the regulation as it is.

a. Yes, it would be too good to be true, so a Roth IRA isn't an eligible shareholder. Taproot Administrative Services, Inc. v. Commissioner, 679 F.3d 110 (9th Cir. 3/21/12). The Court of Appeals affirmed the Tax Court's holding that a Roth IRA is not an eligible shareholder for an S corporation, and that the taxpayer corporation thus was a C corporation. Although the Court of Appeals "adopt[ed] the Tax Court's reasoning," it concluded that "the analysis requires further elaboration," because the Tax Court's focus "fail[ed] ... to squarely address Taproot's alternative argument for eligibility as the legal owner of the individual shares of stock comprising the IRA." The taxpayer argued that "both forms of IRAs – trusts and custodial accounts – lack the essential attributes of a separate tax-paying entity and consequently should be treated as legally indistinguishable from their individual owners." But the Court of Appeals concluded that the reasoning behind Revenue Ruling 92-73, 1992-2 C.B. 224, "unequivocally supports the opposite result." Furthermore, the legislative history of subchapter S favors limited eligibility, and "[a]ccording to the legislative history of the ESOP eligibility amendment, ... Congress did not envision IRAs as permissible shareholders at the time of enactment." The court also rejected the taxpayer's argument that the language of Reg. § 1.1361-1(e), which provides guidance regarding determining the number of shareholders of a corporation statute, stating that "[t]he person for whom stock of a corporation is held by a nominee, guardian, custodian, or an agent is considered to be the shareholder ... directly authorizes ownership of S corporation stock by IRAs and Roth IRAs created as custodial accounts." Rather, the court agreed with the IRS's argument that "the language of the regulation requires consideration of who ultimately bears the tax responsibility from its application," and concluded that "[a]pplying this logic, custodial IRAs and Roth IRAs are different in kind and therefore distinguishable from other custodial accounts, such as those involving minors or disabled individuals." The court emphasized that "[t]o adopt the position Taproot urges, this Court must conclude that Congress consciously crafted a legislative scheme enabling shareholders to employ Roth IRAs to perpetually avoid any taxation on S corporation profits. The legislative history and regulatory record foreclose this conclusion."

4. S corporation shareholders aren't allowed to just make up their own basis adjustment rules. Barnes v. Commissioner, T.C. Memo. 2012-80 (3/21/12) The Tax Court (Judge Morrison) agreed with the IRS in holding – unsurprisingly – that there is no upward stock basis adjustment under § 1367 for amounts that are erroneously reported by the shareholder as § 1366 pass through income but that do not correspond to, but exceed, the shareholder's actual pro rata share of pass through income. Likewise, § 1367(a)(2)(B) requires an S corporation shareholder to reduce stock basis by any losses that the shareholder is required to take into account under § 1366(a)(1)(A), even if the shareholder does not actually claim the pass through losses on the shareholder's return. Because the taxpayer had reported gain rather than loss in a prior year in which a very large loss had been passed through, the shareholder had no basis to support passed-through losses in the year in question.

5. **An S corporation is not an individual, even if an IRS employee said so.** Trugman v. Commissioner, 138 T.C. No. 22 (5/21/12). The taxpayers moved from California to Nevada to avoid state income taxes. The acquired a principal residence in Henderson, Nevada through their wholly owned S corporation, which held rental properties in Missouri, Texas, and California. The taxpayer's claimed the $8,000 first time home-buyer's credit under now-expired § 36, which was available to an "individual" who had no present ownership interest in a principal residence during the three year period ending on the date of the purchase. The Tax Court (Judge Kroupa), in a case of first impression, held that a corporation is not an individual for purposes of § 36, and election of subchapter S status does not change that characterization. The pass-through nature of the credit did not alter the fact that the corporation purchased the property. The court pointed out that individuals can have a principal residence, but a corporation has a principal place of business. The court also was unsympathetic to the taxpayer's request for leniency on the grounds that an IRS representative advised them that they could claim the credit if the residence was purchased through an S corporation. The court pointed out that the Commissioner is not bound by the erroneous legal advice of IRS employees.

6. **Paper is substance. Corporate resolutions and ledger entries create an "economic outlay." — No kidding, they really do, says Judge Ruwe.** Maguire v. Commissioner, T.C. Memo. 2012-160 (6/6/12). The taxpayers in these consolidated cases owned two S corporations with related businesses – one was an auto dealership, and the other a finance company that purchased customer notes from the auto dealership. The finance company operated at a profit and the dealership operated at a loss. Apart from the transactions at issue, the taxpayers did not have sufficient basis in the dealership to deduct losses, but had substantial basis in the finance company. The finance company owned substantial accounts receivable due from the dealership. At the end of each year, through journal entries, the finance company distributed accounts receivable to the taxpayers, who in turn contributed them to the related dealership to increase the basis in the dealership sufficiently to avoid the § 1366(d) limitation on the deduction of passed through losses. The IRS disallowed the claimed loss deductions on the grounds that the transactions did not increase the taxpayers' basis in the dealership because the transactions because the taxpayers had not made an "an economic outlay." The IRS argued that the "corporate resolutions and adjusting journal entries made to the books of the related companies were devoid of any economic reality and did not alter the economic positions of the parties." The Tax Court (Judge Ruwe) rejected the IRS's position and held for the taxpayer, finding that the "distributions and contributions did have real consequences that altered the positions of petitioners individually and those of their businesses." Thus, the transactions did result in the taxpayer making the required "economic outlay."

> [T]he distributions and contributions created actual economic consequences for the parties, because the accounts receivable had real value in that they were legitimate debts that Auto Acceptance owed to CNAC and thus were legitimate assets of CNAC. Petitioners' contribution of the accounts receivable resulted in their being poorer in a material sense in that the accounts receivable were no longer collectible by them individually.

- Judge Ruwe added that he saw "no reason why shareholders in two related S corporations should be prohibited from taking distributions of assets from one of their S corporations and investing those assets into another of their S corporations, in order to increase their bases in the latter. The effect is to decrease the shareholders' bases in the S corporation making the distribution, thereby reducing the shareholders' potential future tax-free distributions from the distributing S corporation, while increasing the shareholders' bases in the S corporation to which the contribution is made." Furthermore, "[t]he fact that the two S corporations have a synergistic business relationship and are owned by the same shareholders should make no difference so long as the underlying distributions and contributions actually occurred."

- But for the fact that the shareholders' ownership of the two corporations was not congruent, this issue could have been avoided by having the two operating corporations organized as subsidiary QSubs of an S corporation holding company.

7. **The Treasury Department proposes major surgery on the rules for determining an S corporation shareholder's basis limitation for passed-through losses under § 1366(d).** REG-134042-07, Basis of Indebtedness of S Corporations to Their Shareholders, 77 F.R. 34884 (6/12/12). The Treasury Department has proposed amendments to Reg. § 1.1366-2 that would deal with determination of an S corporation shareholder's basis in any debt of the S corporation, which principally affects the limitation on the pass-through of losses under § 1366(d). The proposed regulations expressly provide that the basis of any indebtedness of the S corporation to the shareholder means the shareholder's adjusted basis (as defined in Reg. § 1.1011-1 and as provided in § 1367(b)(2)) in any "bona fide indebtedness of the S corporation that runs directly to the shareholder." Whether indebtedness is "bona fide indebtedness" to a shareholder is determined under general tax principles and depends on "all of the facts and circumstances." Prop. Reg. § 1.1366-2(a)(2)(i). Furthermore, the proposed regulations expressly provide that:

> A shareholder does not obtain basis of indebtedness in the S corporation merely by guaranteeing a loan or acting as a surety, accommodation party, or in any similar capacity relating to a loan. When a shareholder makes a payment on bona fide indebtedness for which the shareholder has acted as guarantor or in a similar capacity, based on the facts and circumstances, the shareholder may increase its basis of indebtedness to the extent of that payment.

- The preamble states that "[u]nder these proposed regulations, an incorporated pocketbook transaction [see, e.g., *Yates v. Commissioner*, T.C. Memo. 2001-280; *Culnen v. Commissioner*, T.C. Memo. 2000-139] increases basis of indebtedness only where the transaction creates a bona fide creditor-debtor relationship between the shareholder and the borrowing S corporation."

- Prop. Reg. § 1.1366-2(a)(2)(ii), Example (3) in the proposed regulation blesses a basis increase resulting from a back-to-back loan in which one S corporation lends money to the shareholder who in turn lends the loan proceeds to a second S corporation, if the loan to the second S corporation "constitutes bona fide indebtedness" from the borrower S corporation to the shareholder. Example (4) in the proposed regulation blesses a basis increase resulting from a distribution of a note from one S corporation (S2) to another S corporation (S1) if after the distribution S2 is indebted to the shareholder and "the note constitutes bona fide indebtedness" from S2 to the shareholder.

- The proposed regulations do not attempt to clarify the meaning of "bona fide indebtedness," or provide any examples of relevant facts and circumstances, but rely on "general Federal tax principles." This may portend that the voluminous debt versus equity jurisprudence might replace the "actual economic outlay" by the shareholder test for creating basis of indebtedness, applied in cases such as *Maloof v. Commissioner*, 456 F.3d 645 (6th Cir. 2006); *Spencer v. Commissioner*, 110 T.C. 62, 78-79 (1998), *aff'd without published opinion*, 194 F.3d 1324 (11th Cir. 1999); *Hitchins v. Commissioner*, 103 T.C. 711 (1994); and *Perry v. Commissioner*, 54 T.C. 1293 (1970). The preamble refers to *Knetsch v. United States*, 364 U.S. 361 (1960) (disallowing interest deductions for lack of actual indebtedness); *Geftman v. Commissioner*, 154 F.3d 61 (3d Cir. 1998); *Estate of Mixon v. U.S.*, 464 F.2d 394 (5th Cir. 1972); and *Litton Business Systems, Inc. v. Commissioner*, 61 T.C. 367 (1973), as relevant authorities.

- The proposed regulations do not address how to determine the basis of the shareholder's stock in the S corporation. Rev. Rul. 81-187, 1981-2 C.B. 167, provides that a shareholder of an S corporation does not increase basis in stock for purposes of § 1366(d)(1)(A) by contributing the shareholder's own unsecured demand promissory note to the corporation. In the preamble, the Treasury Department and the IRS have requested comments concerning the propriety of basis calculations in the S corporation and partnership context, similar to the one currently in Reg. § 1.704-1(b)(2)(iv)(d)(2), which provides that a partner's capital account is increased with respect to non-readily tradable partner notes only (i) when there is a taxable disposition of such note by the partnership, or (ii) when the partner makes principal payments on such note.

- The proposed regulations will apply to loan transactions entered into on or after the date of publication of final regulations.

8. **Shareholder consent to an S election constitutes consideration paid to the S corporation for cash distributions. — Say What!** In re Kenrob Information Technology Solutions, Inc., 110 A.F.T.R.2d 2012-5190 (Bankr. E.D. Va. 7/10/12). Kenrob was an S corporation in bankruptcy. Pursuant to a long-standing pre-existing agreement between the corporation and the shareholders, the corporation had paid directly to the IRS the personal income taxes attributable to the shareholders' passed-through income. The trustee asserted that the payments were fraudulent conveyance because they were made without consideration by the corporation. The Bankruptcy court rejected the trustee's argument, holding that the consideration received by the corporation was the shareholders' "election" — the court should have said "consent" to have the corporation be taxed as an S corporation — as long as the corporation paid the resulting personal income tax liability. The benefit to the corporation was the § 11 taxes that it would not have had to pay had it not made the S election.

E. Mergers, Acquisitions and Reorganizations

1. **Tracking the basis of nonexistent stock ain't easy.** T.D. 9558, Corporate Reorganizations; Allocation of Basis in "All Cash D" Reorganizations, 76 FR 71878 (11/21/11). Temp. Reg. § 1.358-2T deals with stock basis in all cash type D reorganizations under Reg. § 1.368-2(*l*). If an actual shareholder of the acquiring corporation is deemed to receive a nominal share of stock of the issuing corporation described in Reg. § 1.368-2(*l*), that shareholder must, after allocating and adjusting the basis of the nominal share in accordance with the rules of Reg. § 1.358-1, and after adjusting the basis in the nominal share for any transfers described in Reg. § 1.358-1, designate the share of stock of the acquiring corporation to which the basis, if any, of the nominal share will attach. Under these rules, the ability to designate the share of stock of the acquiring corporation to which the basis of the surrendered stock or securities of the target will attach applies only to a shareholder that actually owns shares in the issuing corporation. Thus, for example, if in an all cash D reorganization, Y Corporation, a first tier subsidiary of P Corporation, acquires the assets of T Corporation, a second tier subsidiary of P Corporation, owned by X Corporation, a first tier subsidiary of P Corporation, X Corporation cannot designate any share of Y Corporation stock to which the basis, if any, of the nominal share of Y Corporation stock will attach; and P Corporation cannot designate a share of Y Corporation stock to which basis will attach because P Corporation's basis in the nominal share of Y Corporation stock (deemed to have been distributed to it by X Corporation) is zero (its fair market value).

2. **"[A]doption of these exceptions [to § 382(g)] is appropriate because these transactions do not introduce new capital into the loss corporation and because direct or indirect ownership of the loss corporation becomes less concentrated, thus diminishing the opportunity for loss trafficking."** REG–149625–10, Application of the Segregation Rules to Small Shareholders, 76 F.R. 72362 (11/23/11). The Treasury Department has published proposed amendments to Reg. § 1.382-3 that would reduce the complexity of applying § 382 in tracking transactions involving small amounts of stock of a loss corporation. Reg. § 1.382-3 currently provides that all shareholders who do not individually own five percent of a loss corporation are grouped together and treated as a single "public group" five-percent shareholder. However, current Temp. Reg. § 1.382-2T segregates into two or more public groups any public group of less than five percent stockholders that can be separately identified as having acquired their stock in a particular transaction. The proposed regulations would provide that the segregation rule does not apply to transfers of a loss corporation's stock to non-five-percent shareholders by five- percent shareholders, or entities that directly or indirectly own at least five percent of a loss corporation whose owners (excluding those who are five percent shareholders

Back to Table of Contents

of a loss corporation) own, in the aggregate, five percent or more of a loss corporation. The proposed regulations also would provide that the segregation rules do not apply to transfers of ownership interests in five-percent entities to shareholders who are not themselves five-percent shareholders. The proposed regulations also provide a special exception under which a loss corporation may annually redeem ten percent of the value of its stock, or 10 percent of the shares of a particular class of stock, without triggering the segregation rules and the creation of new 5 percent groups. Under the proposed regulations, transactions that under the current rules result in the creation of a new public group, and thus a possible owner shift, simply will be folded into the existing public groups, thereby reducing the chance of an ownership change.

3. Corporate shareholders knew what MidCoast's midco deal was all about. Transferee liability imposed. Feldman v. Commissioner, T.C. Memo. 2011-297 (12/27/11). The Tax Court (Judge Swift) upheld transferee liability against the shareholders of a corporation who sold the stock of the corporation engaged in a purported stock sale to a midco (the infamous MidCoast) to avoid recognition of gain from earlier sale of the corporation's assets. The transaction was structured as a stock redemption for cash after the asset sale, with the remainder of the stock being sold in the same taxable year of the corporation to a midco that purported to shelter the gains with losses from purported distressed debt tax shelter transactions. The purported stock sale "lack[ed] both business purpose and economic substance" and was disregarded for federal income tax purposes. "The substance of the transaction was a liquidation [of the corporation] and a fee payment to MidCoast for its role in facilitating the sham." The court specifically noted that the taxpayers took no actions to ensure that the corporate income tax liability triggered by the asset sale would be paid, and that it remained unpaid.

a. A different Tax Court judge sees a somewhat differently structured MidCoast deal as immune from transferee liability. Frank Sawyer Trust of May 1992 v. Commissioner, T.C. Memo. 2011-298 (12/27/11). The Tax Court (Judge Goeke) refused to uphold transferee liability against the shareholders of a corporation who sold the stock of the corporation engaged to a midco (Fortrend), which was brought into the deal by the infamous MidCoast to provide financing) after an asset sale. He found that the shareholders knew little about the mechanics of the transaction and exercised due diligence.

> The trust representatives believed Fortrend's attorneys to be from prestigious and reputable law firms. They assumed that Fortrend must have had some method of offsetting the taxable gains within the corporations. They performed due diligence with respect to Fortrend to ensure that Fortrend was not a scam operation and that Fortrend had the financial capacity to purchase the stock. The trust representatives believed Fortrend assumed the risk of overpaying for the Taxi corporations if they did not have a legal way for offsetting or reducing the tax liabilities.

• Judge Goeke applied state fraudulent conveyance law to determine whether the transactions should be collapsed and concluded that they should not, because the IRS, which has the burden of proof in transferee liability cases, did not prove that "the purported transferee had either actual or constructive knowledge of the entire scheme." Because in this case the transaction was structured in such a manner that the corporation never made any payments to the shareholders, there was no actual or constructive fraudulent transfer to the shareholders. Finally, turning to federal tax law, Judge Goeke held that "substance over form and its related doctrines [were] not applicable," because the transaction was an arm's length stock sale between the shareholders and a purchaser in which the parties agreed that the purchaser would be responsible for reporting and paying the corporation's income taxes. "There was no preconceived plan to avoid taxation ... ." Judge Goeke distinguished Feldman v. Commissioner, T.C. Memo. 2011-297 (12/27/11), supra, because in that case "[i]t was 'absolutely clear' that the taxpayer was aware the stock purchaser had no intention of ever paying the tax liabilities [and] the taxpayer did not conduct thorough due diligence of the stock purchaser ... ."

b. And yet another shareholder escapes transferee liability after yet another MidCoast midco transaction. Slone v. Commissioner, T.C. Memo. 2012-57

(3/1/12). The taxpayer's family owned corporation sold all of its assets for cash, resulting in a gain of over $38 million and an estimated combined federal and state income tax liability of over $15 million. None of the proceeds had been distributed at the time Fortrend and MidCoast made an unsolicited offer to purchase the stock of the corporation, which ultimately was accepted, at a purchase price of $35,753,000, plus assumption of the corporation's federal and state income taxes owed as of the closing date. Not unsurprisingly, the taxes were never paid and the IRS asserted transferee liability against the shareholders. Because the asset sale and stock sale were independent of each other and the shareholders "had no reason to believe that Fortrend's methods were illegal or inappropriate, ... [n]either the substance over form doctrine nor any related doctrines appl[ied] to recast the stock sale as a liquidating distribution." Thus, because the IRS's transferee liability theory was grounded on recasting the stock sale as a liquidation, the IRS lost.

c. And the IRS loses yet again on similar facts but with different "bad guys." Salus Mundi Foundation v. Commissioner, T.C. Memo. 2012-61 (3/6/12). Judge Goeke found that the case was similar to *Frank Sawyer Trust* and *Sloane*, *supra*, and unlike *Feldman*, *supra*. Actually, the facts here were even better for the taxpayer – the stock sale preceded the asset sale to the unrelated schemer, so there was no corporate tax liability at the time the stock was sold.

d. And the IRS's batting average continues to sag. Starnes v. Commissioner, 680 F.3d 417 (4th Cir. 5/31/12), *aff'g* T.C. Memo. 2011-63. The Fourth Circuit refused to apply transferee liability under § 6901 against the shareholders of a corporation (Tarcon) who sold the stock of a corporation to a MidCoast after an asset sale, even though the corporation had nothing but cash, which pursuant to the contractual provisions was transferred to Midcoast by wire transfer contemporaneously with the closing of the stock sale and purchase, even though the purchase price was substantially less than the cash holdings of the corporation. The Court of Appeals held that under *Commissioner v. Stern*, 357 U.S. 39 (1958), whether a "person is the 'transferee' of a taxpayer's assets, the 'existence and extent' of that transferee's liability for unpaid taxes the taxpayer owed prior to the transfer is determined by state law, not federal law." (It failed to consider the impact of the Federal Debt Collection Act, which postdates Stern.) The court also held that *Stern* forecloses the application of federal tax law principles to recast of the actual transactions under federal law before applying state law to the set of transactions: "An alleged transferee's substantive liability for another taxpayer's unpaid taxes is purely a question of state law, without an antecedent federal-law recasting of the disputed transactions."

- A cogent dissent by Judge Wynn would have imposed transferee liability.
- Judge Wynn would have followed *BB&T Corp. v. United States*, 523 F.3d 461, 472 (4th Cir. 2008) – "[i]n applying the doctrine of substance over form, we 'look to the objective economic realities of a transaction rather than to the particular form the parties employed'" (quoting *Frank Lyon*, 435 U.S. at 573 (alteration omitted)) to recast the transaction because "the 'objective economic realities' establish that the former shareholders effectively wound up Tarcon and received liquidating distributions of its cash as a result of the stock sale to MidCoast." Judge Wynn reasoned that the sale to MidCoast was not a true sale of stock. Rather, the "substance" of the transaction was merely a cash-for-cash swap and because cash is fungible, the transaction in substance was a receipt by the former shareholders of distributions of Tarcon's cash. Finally, because the stock sales agreement did not require that Tarcon get anything in return for its cash, this transfer was clearly fraudulent under the relevant state law.

4. When to measure the value of consideration to determine whether continuity of interest exists: It is the business day before the day on which the binding contract is entered into. Continuity of interest regulations revised, finally! T.D. 9565, Corporate Reorganizations; Guidance on the Measurement of Continuity of Interest, 76 F.R. 78540 (12/19/11). The Treasury Department finalized, with only minor changes, Prop. Reg. § 1.368-1(e)(2), REG-146247-06, Corporate Reorganizations; Guidance on the Measurement of Continuity of Interest, 72 F.R. 13058 (3/20/07), which were identical to Temp. Reg. § 1.368-

Back to Table of Contents

1(e)(2), which had expired on 3/19/10. Reg. § 1.368-1(e)(2)(i) provides that for purposes of determining whether shareholders received a sufficient proprietary interest in the acquiring corporation, the value of consideration received in a reorganization is determined as of the last business day before the contract is binding, if the contract provides for fixed consideration. Under Reg. § 1.368-1(e)(2)(iii)(A), a contract provides for fixed consideration if it specifies the number of shares of the acquiring corporation, the amount of money, and the other property (identified by value or by description) that is to be exchanged for the stock of the target corporation. With an Orwellian flourish, Reg. § 1.368-1(e)(2)(iii)(C)(1) states that "a contract that provides for contingent consideration will be treated as providing for fixed consideration if it would satisfy the requirements of paragraph (e)(2)(iii)(A) of this section without the contingent adjustment provision." Reg. § 1.368-1(e)(2)(iii)(C)(2) adds that contingent consideration will not be fixed consideration if the adjustments prevent the target shareholders from being subject to the economic benefits and burdens of ownership of the acquiring corporation stock as of the last business day before a binding contract. Thus, adjustments that reflect changes in the value of the stock or assets of the acquiring corporation at a later date will prevent the contract from being treated as providing for fixed consideration. The preamble to the Temporary Regulations, T.D. 9316, 72 F.R. 12974 (2007), suggested that the contingent consideration provision allows adjustments to the consideration that do not decrease the ratio of the value of the shares of the acquiring corporation to the value of money or other property delivered to the target shareholders relative to the ratio of the value of the target stock to the value of the money or other property that would be delivered to the target shareholders if none of the contingent consideration were delivered.

- Under Temp Reg. § 1.368-1(e)(2)(iii)(B), if the target corporation's shareholders may elect to receive either stock or money, the contract provides for fixed consideration if the determination of the number of shares of issuing corporation stock to be provided to the target corporation shareholder is based on the value of the issuing corporation stock on the last business day before the first date there is a binding contract. The preamble to the Temporary Regulations indicates that the IRS and Treasury Department believe that if shareholders have an election to receive stock of the acquiring corporation at an exchange rate based on the value of the acquiring corporation stock on the date of a binding contract, the target shareholders are at risk for the economic benefits and burdens of ownership of the acquiring corporation stock as of the contract date. Thus, the preamble concludes that it is appropriate to value the stock of the acquiring corporation as of the signing date for purposes of testing continuity of interest. Reg. § 1.368-1(e)(2)(v), Ex. (9) provides an example of the application of the shareholder election.

- Reg. § 1.368-1(e)(2)(ii)(A) provides that a binding contract is an instrument enforceable under applicable law. However, the presence of a condition outside of the control of the parties, such as a requirement for regulatory approval, will not prevent an instrument from being treated as a binding contract. Reg. § 1.368-1(e)(2)(ii)(C) provides rules pursuant to which a tender offer can be considered to be a binding contract, even though it is not enforceable against the offerees, if certain conditions are met. The regulations also provide for modifications of a binding contract. If the contract is modified to change the amount or type of consideration that the target shareholders would receive, the date of the modification becomes a new signing date for purposes of testing for continuity of interest. Reg. § 1.368-1(e)(2)(ii)(B)(1). However, if in a transaction that provides for adequate continuity of interest, the contract is modified to increase the amount of stock of the acquiring corporation to be delivered to the target shareholders, or to decrease the amount of cash or value of other property, then the modification will not be treated as a modification of the binding contract. Reg. § 1.368-1(e)(2)(ii)(B)(2). Similarly, in a transaction that does not qualify as a reorganization for failure to meet the continuity of interest requirement, a modification that reduces the number of shares of stock to be received by the target shareholders, or increases the amount of money or value of property, will not be treated as a modification of the binding contract so that the consideration will continue to be valued as of the signing date. Reg. § 1.368-1(e)(2)(ii)(B)(3). Reg. § 1.368-1(e)(2)(iii)(D) provides that stock that is escrowed to secure customary pre-closing covenants and representations and warranties is not treated as contingent consideration, which would render the safe harbor unavailable. However, escrowed consideration that is forfeited, is not taken into account in determining whether the continuity of interest requirement has been met. Reg. § 1.368-1(e)(2)(iv), Ex. 2.

- Notice 2010-25, 2010-1 C.B. 527 (3/17/10), provided that, until the issuance of new regulations, taxpayers could choose (subject to strict consistency rules) to apply the proposed regulations after the expiration of the Temporary Regulations. The ability of taxpayers to elect to apply the rules of the proposed regulations, as provided in the Notice, is incorporated into Reg. § 1.368-1(e)(9)(ii).

a. **Still work left to be done. Isn't that always true?** REG-124627-11, Corporate Reorganizations; Guidance on the Measurement of Continuity of Interest, 76 F.R. 78591 (12/19/11). The Treasury Department has published Prop. Reg. § 1.368-1(e)(2)(vi), under which application of the signing date principles for determining whether continuity of interest is satisfied would be expanded. The proposed regulations would also permit the use of an average value for issuing corporation stock, in lieu of the value of issuing corporation stock on the closing date, in certain circumstances. An average value could "be used if it is based on issuing corporation stock values occurring after the signing date and before the closing date, and the binding contract utilizes the average price, so computed, in determining the number of shares of each class of stock of the issuing corporation, the amount of money, and the other property to be exchanged for all the proprietary interests in the target corporation, or to be exchanged for each proprietary interest in the target corporation." This rule applies signing date rule "principles," because "the target shareholders become subject to the fortunes of the issuer's stock across the range of dates being averaged."

- The proposed regulations would apply to transactions occurring on or after they are finalized, unless the transaction was completed pursuant to a binding agreement that was in effect immediately before the date such final regulations are published and all times afterwards.

5. **The Treasury proposes what is essentially elective location of e&p following asset-acquisition reorganizations.** REG–141268–11, Allocation of Earnings and Profits in Tax-Free Transfers From One Corporation to Another, 77 F.R. 22515 (4/16/12). The Treasury Department has published proposed amendments to Reg. § 312-11(a) that would provide that in a transfer described in § 381 – which applies to tax-free § 368 asset-acquisitions and § 332 liquidations – only the acquiring corporation, as defined in Reg. § 1.381(a)–1(b)(2), succeeds to the earnings and profits of the distributor or transferor corporation unless the second transfer also is described in § 381(a). Thus, if following an asset-acquisition reorganization all of the target's assets are dropped to a subsidiary of the acquiring corporation, the earnings and profits move to the subsidiary, but if the acquiring corporation retains any assets, then it retains all of the earnings and profits. Amended Reg. § 312-11(a) will not apply if Reg. § 1.312-10 applies in the case of a § 355 distribution.

F. Corporate Divisions

1. **"Hot stock" cools off in a DSAG.** T.D. 9548, Guidance Regarding the Treatment of Stock of a Controlled Corporation Under Section 355(a)(3)(B), 76 F.R. 65110 (10/20/11). The Treasury has promulgated amendments to Reg. § 1.355-2(g) and (i) to replace Temporary Regulations promulgated in T.D. 9435, Guidance Regarding the Treatment of Stock of a Controlled Corporation Under Section 355(a)(3)(B), 73 F.R. 75946 (12/25/08), and proposed in REG-150670-07, Guidance Regarding the Treatment of Stock of a Controlled Corporation Under Section 355(a)(3)(B), 73 F.R. 75979 (12/15/08). The final regulations adopt the substantive rules of the temporary regulations without change. Reg. § 1.355-2(g), deals with the "hot stock" rule of § 355(a)(3)(B) to conform to the 2006 amendments of § 355(b)(3), creating the "SAG" rules, which treat a corporation's SAG [separate affiliated group] as a single corporation for purposes of determining whether the active trade or business requirements of § 355 have been met. Section 355(a)(3)(B) provides that stock of a controlled corporation that has been acquired by the distributing corporation in a taxable transaction within the five year period preceding distribution to stockholders otherwise qualifying under § 355 will be treated as

boot taxable to the stockholders. Generally speaking, the temporary regulations provide that the hot stock of § 355(a)(3)(B) rule does not apply to any acquisition of stock of controlled where controlled is a DSAG [separate affiliated group of the distributing corporation] member at any time after the acquisition (but prior to the distribution of controlled). Transfers of controlled stock owned by DSAG members immediately before and immediately after the transfer are disregarded and are not treated as acquisitions for purposes of the hot stock rule. (Prop. Reg. § 1.355- 3(b)(1)(ii) would apply a similar rule for purposes of the active trade or business requirement.) The temporary regulations also incorporate the exception of former Reg. § 1.355-2(g), which provides that the hot stock rule does not apply to acquisitions of controlled stock by a distributing corporation from a member of the affiliated group (as defined in Reg. § 1.355-3(b)(4)(iv)) of which the distributing corporation was a member. The final regulations generally apply to distributions occurring after 10/20/11. (The Temporary Regulations generally apply to distributions occurring after 12/15/08, but there are a number of transition rules. Taxpayers also may elect to apply the regulations to distributions made after 5/17/06.)

G. Affiliated Corporations and Consolidated Returns

1. **Section 382 alone is complicated; the consolidated return rules alone are complicated. When the time comes to apply § 382 to consolidated returns, only rocket scientists need apply.** REG–133002–10, Redetermination of the Consolidated Net Unrealized Built-In Gain and Loss, 76 F.R. 65634 (10/24/11). The Treasury and IRS have published proposed amendments to Reg. § 1.1502-91(g), which provides rules for determining whether an acquired loss group has a net unrealized built-in gain (NUBIG) or a net unrealized built-in loss (NUBIL) for purposes of applying § 382 in the consolidated return context. Under the current regulations, Reg. § 1.1502–91(g)(1) provides that the determination of whether a loss group has a consolidated NUBIG or NUBIL is based on the aggregate amount of the separately determined NUBIGs and NUBILs of each member included in the loss group. Under this rule, unrealized gain or loss with respect to the stock of a member of the loss group (an included subsidiary) is disregarded in determining the separately determined NUBIG or NUBIL. The proposed amendments would modify the current regulations to take into account the unduplicated gain or loss on stock of included subsidiaries, but only to the extent that such gain or loss is taken into account by the group during the recognition period. This will generally be the case only if, within the recognition period, such stock is sold to a nonmember or becomes worthless, or a member takes an intercompany item into account with respect to such stock.

H. Miscellaneous Corporate Issues

VII. PARTNERSHIPS

A. Formation and Taxable Years

1. **Foreign tax credit shelter fails to deliver because the investment was a loan rather than a partnership.** Pritired 1, LLC v. United States, 816 F. Supp. 2d 693 (D. Iowa 9/30/11). The District Court granted summary judgment to the IRS on a partnership refund claim for deficiencies imposed on denial of $21 million of foreign tax credits. Pritired, the taxpayer LLC, was formed as a partnership by Principal Life Insurance Company (a subsidiary of Principal Financial Group) and Citibank. Pritired invested $300 million in a French equivalent of an LLC along with two French Banks. Pritired received $9 million of class B shares of the French LLC plus $291 million of “perpetual certificates” structured to provide a LIBOR based return. The interest payments were offset with LIBOR based swaps that the court described as equivalent to providing an interest rate less French taxes. The court found that the only return available to Pritired was the value of foreign tax credits. The French banks contributed $930 million to the French LLC in exchange for $455 million of class A stock and $455 million of one percent convertible notes. The $1.2 billion was invested in low return securities. The foreign tax credits on the $1.2 billion investment returns were allocated by the French LLC to Pritired. The French banks treated the transaction as a debt. Pritired asserted that through the swap mechanism its investment in the class B shares and the perpetual certificates constituted an equity investment in the French LLC that was a partnership. The court described the transaction as follows:

> Through this transaction, the French banks were able to borrow three hundred million dollars at below market rates. The American companies received a very high return on an almost risk free investment. Only one thing could make such a transaction so favorable to everyone involved. United States taxpayers made it work.

- The court applied traditional debt/equity concepts, to conclude that the transaction represented a loan to the French banks rather than an equity investment. Based on the attributes of debt specified in Notice 94-47, 1994-1 C.B. 357, the court ultimately found that the class B shares and the perpetual certificates had more debt-like attributes than equity-like attributes. The court then concluded that "as a practical matter" the transaction was structured to be a loan rather than an equity investment treated as partnership, citing *TIFD III-E, Inc. v. United States* (*Castle Harbour*), 459 F.3d 220, 236 (2d Cir. 2006). The court also concluded that the transaction lacked economic substance. Although the transaction was designed to appear as a partnership equity investment, it was primarily structured to generate foreign tax credits. The court applied the anti-abuse rule of Reg. § 1.701-2 to disregard the partnership and disallow the foreign tax credits claimed by the U.S. taxpayers for French taxes purportedly paid by the French LLC. Given these holdings, the court found it unnecessary to address the IRS's additional argument that allocation of the French taxes to the Pritired lacked substantial economic effect under Reg. § 1.704-2(b)(2).

2. The *Castle Harbour* saga. Will it ever end? The Second Circuit twice reverses a taxpayer victory in a self-liquidating partnership note transaction, in which the lion's share of income was allocated to a tax-indifferent party, on the ground that the tax-indifferent Dutch banks were not really equity partners. TIFD III-E, Inc. v. United States, 342 F. Supp. 2d 94 (D. Conn. 11/1/04), *rev'd*, 459 F.3d 220 (2d Cir. 8/3/06), *on remand*, 660 F. Supp. 2d 367, *as amended*, 2009 U.S. Dist. LEXIS 98884 (D. Conn. 10/23/09), *rev'd*, 666 F.3d 836 (2d Cir. 1/24/12).

a. *Castle Harbour I*: District Court holds for the taxpayer. The court found that the creation of Castle Harbour, a Nevada LLC, by General Electric Capital Corp. subsidiaries was not designed solely to avoid taxes, but to spread the risk of their investment in fully-depreciated commercial airplanes used in their leasing operations. GECC subsidiaries put the following assets into Castle Harbour: $530 million worth of fully-depreciated aircraft subject to a $258 million non-recourse debt; $22 million of rents receivable; $296 million of cash; and all the stock of another GECC subsidiary that had a value of $0. Two tax-indifferent Dutch Banks invested $117.5 million in Castle Harbour. Under the LLC agreement, the tax-indifferent partner was allocated 98 percent of the book income and 98 percent of the tax income.

- The book income was net of depreciation and the tax income did not take depreciation into account (because the airplanes were fully depreciated for tax purposes). Depreciation deductions for book purposes were on the order of 60 percent of the rental income for any given year.
- Scheduled distributions in excess of book income would have resulted in the liquidation of the investment of the Dutch banks in eight years, with the Dutch banks receiving a return of approximately nine percent, with some "economically substantial" upside and some downside risk. Castle Harbour was terminated after five years because of a threatened change in U.S. tax law, but during that period about $310 million of income was shifted to the Dutch banks for a tax saving to the GECC subsidiaries of about $62 million.
- Query whether § 704(b) was properly applied to this transaction?
- This appears to be a lease-stripping transaction in which the income from the lease was assigned to foreign entities while the benefits of ownership were left with a domestic entity.
- The court (Judge Underhill) held that satisfaction of the mechanical rules of the regulations under § 704(b) transcended both an intent to avoid tax and the

avoidance of significant tax through agreed upon partnership allocations. In this partnership, 2 percent of both operating and taxable income was allocated to GECC, a United States partner, and 98 percent of both book and taxable income was allocated to partners who were Dutch banks. The Dutch banks were foreign partners who were not liable for United States taxes and thus were indifferent to the U.S. tax consequences of their participation in the partnership. Because the partnership had very large book depreciation deductions and no tax depreciation, most of the partnership's taxable operating income, which was substantially in excess of book taxable income, was allocated to the tax-indifferent foreign partners, even though a large portion of the cash receipts reflected in that income was devoted to repaying the principal of loans secured by property that GECC had contributed to the partnership. The overall partnership transaction saved GECC approximately $62 million in income taxes, and the court found that "it appears likely that one of GECC's principal motivations in entering into this transaction – though certainly not its only motivation – was to avoid that substantial tax burden." The court understood the effects of the allocations and concluded that "by allocating 98% of the income from fully tax-depreciated aircraft to the Dutch Banks, GECC avoided an enormous tax burden, while shifting very little book income." Put another way, by allocating income less depreciation to tax-neutral parties, GECC was able to "re-depreciate" the assets for tax purposes. The tax-neutrals absorbed the tax consequences of all the income allocated to them, but actually received only the income in excess of book depreciation. Nevertheless, the court upheld the allocations. "The tax benefits of the … transaction were the result of the allocation of large amounts of book income to a tax-neutral entity, offset by a large depreciation expense, with a corresponding allocation of a large amount of taxable income, but no corresponding allocation of depreciation deductions. This resulted in an enormous tax savings, but the simple allocation of a large percentage of income violates no rule. The government does not – and cannot – dispute that partners may allocate their partnership's income as they choose. Neither does the government dispute that the taxable income allocated to the Dutch Banks could not be offset by the allocation of non-existent depreciation deductions to the banks. And … the bare allocation of a large interest in income does not violate the overall tax effect rule."

- Judge Underhill concluded:

> The government is understandably concerned that the Castle Harbour transaction deprived the public fisc of some $62 million in tax revenue. Moreover, it appears likely that one of GECC's principal motivations in entering into this transaction - though certainly not its only motivation - was to avoid that substantial tax burden. Nevertheless, the Castle Harbour transaction was an economically real transaction, undertaken, at least in part, for a non-tax business purpose; the transaction resulted in the creation of a true partnership with all participants holding valid partnership interests; and the income was allocated among the partners in accordance with the Internal Revenue Code and Treasury Regulations. In short, the transaction, though it sheltered a great deal of income from taxes, was legally permissible. Under such circumstances, the I.R.S. should address its concerns to those who write the tax laws.

b. *Castle Harbour II*: Second Circuit reverses. 459 F.3d 220 (2d Cir. 8/3/06). The Second Circuit, in an opinion by Judge Leval, held that the Dutch banks were not partners because their risks and rewards were closer to those of creditors than partners. He used the facts-and-circumstances test of *Commissioner v. Culbertson*, 337 U.S. 733 (1949), to determine whether the banks' interest was more in the nature of debt or equity and found that their interest was overwhelmingly in the nature of a secured lender's interest, "which would neither be harmed by poor performance of the partnership nor significantly enhanced by extraordinary profits."

- In *ACM* (Colgate), Judge Laro wrote a 100+ page analysis to find that there was no economic substance to the arrangement. The next contingent payment installment sale case in the Tax Court was *ASA Investerings* (Allied Signal), in which Judge Foley wrote a much shorter opinion finding that the Dutch bank was not a partner; the D.C. Circuit affirmed on Judge Foley's holding that the Dutch bank was not a partner. The IRS began to pick up this lack-of-partnership argument and began to use it on examinations. Later, the Tax Court (Judge Nims) used the economic substance argument in *Saba* (Brunswick), which the DC Circuit remanded based on *ASA Investerings* to give taxpayer the opportunity to argue that there was a valid partnership, which it could not do, as Judge Nims found on remand. Even later, the D.C. Circuit reversed the District Court's *Boca* (Wyeth or American Home Products) case based upon this lack-of-partnership argument – even though Cravath planned *Boca* carefully so that if the Dutch bank was knocked out, there would still be a partnership – based upon its *ASA Investerings* and *Saba* findings on appeal that there was no partnership. Now the Second Circuit has adopted the lack-of-partnership argument.

c. ***Castle Harbour III*. Judge Underhill still likes GE.** On remand in *Castle Harbour*, the District Court found a valid partnership to have existed under § 704(e) because the heading does not alter the clear language of a statute. A valid family partnership is found in the absence of a family. Additionally, in his contingent penalty findings, Judge Underhill stated that his 2004 taxpayer-favorable decision *ipso facto* means that the taxpayer's reporting position was based upon substantial authority. 660 F. Supp. 2d 367 (D. Conn. 10/7/09), *as amended*, 2009 U.S. Dist. LEXIS 98884 (D. Conn. 10/23/09). In a carefully-written[3] opinion, Judge Underhill held that, while the Second Circuit opinion decided that the partnership did not meet the *Culbertson* totality-of-the-circumstances test ("whether . . . the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise"), it did not address the § 704(e)(1) issue. He held that the Dutch banks did satisfy the requirements of that paragraph, which reads:

> (e) Family partnerships.
>
> (1) Recognition of interest created by purchase or gift. – A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.

- In so holding, he relied upon well-settled law that the title of a statute cannot limit the plain meaning of the text, and that the title is of use only when it sheds light on some ambiguous word or phrase. *See also* I.R.C. § 7806(b).
- It is worth noting that although *Evans v. Commissioner*, 447 F.2d 547 (7th Cir. 1971), *aff'g* 54 T.C. 40 (1970), which Judge Underhill relied upon extensively to reach his conclusion, held that the application of § 704(e)(1) was not limited to the context of family partnerships, *Evans* involved the question who, between two different persons —the original partner or an assignee of the original partner's economic interest—was the partner who should be taxed on a distributive share of the partnership's income. Although in the family context § 704(e) frequently has been applied to determine whether a partnership exists in the first place, Judge Underhill's decision in *Castle Harbour III* is the very first case ever to discover that § 704(e)(1) applies to determine whether an arrangement between two (or more) otherwise unrelated business entities or unrelated individuals constituted a partnership.
- It has sometimes been adduced that the fact that a court of applicable jurisdiction subsequently upholds the tax treatment of a transaction should be a strong argument for the proposition that such tax treatment was based upon substantial authority. With respect to the applicability of penalties should he be reversed on appeal, Judge Underhill stated:

> To a large extent, my holding in Castle Harbour I in favor of the taxpayer demonstrates the substantial authority for the partnership's tax treatment of the Dutch Banks, as does my discussion above of the Dutch Banks' interest in Castle Harbour under section 704(e)(1). In addition, the government's arguments against the substantial authority defense are unavailing.

- Judge Underhill also sought to place the application of the penalty provisions in a temporal context when he stated:

[3] We do not all share the opinion that the opinion is "carefully-written," but Ira thinks so. Ira's college classmate [Judge] Pierre Leval characterized the District Court's analysis as "thorough and thoughtful."

> The government argues that Culbertson and Second Circuit cases like Slifka and Dyer that interpreted Culbertson cannot provide substantial authority for the partnership's tax position because the Second Circuit held in Castle Harbour II that the Dutch Banks were not partners under Culbertson. The government, however, has not pointed to any Second Circuit case or other authority, prior to 1997 and 1998 when the Castle Harbour partners took the tax positions at issue, where the parties' good faith intention or valid business purpose in forming a partnership was not sufficient to support a conclusion of partnership status for tax purposes.

- In the context of the previous two bullet points, it is worth noting that Judge Underhill's observations in the immediately preceding bullet point appears to be consistent with Reg. § 1.6662-4(d)(2)(iv)(C), which provides that whether a position was supported by substantial authority must be determined with reference to authorities in existence at the time. But, Judge Underhill's observations in the second preceding bullet point appear to be inconsistent with both Treas. Reg. § 1.6662-4(d)(2)(iv)(C), and observations in the immediately preceding bullet. However, we are not all in agreement with what Judge Underhill intended the observations in the second preceding bullet point to mean.

d. *Castle Harbour IV*: The Second Circuit smacks down the District Court again in an opinion that leaves you wondering why it ever remanded the case in the first place. 666 F.3d 836 (2d Cir. 1/24/12). In another opinion by Judge Leval, the Second Circuit again reversed Judge Underhill and held that the enactment of § 704(e)(1), which recognizes as a partner one who owns a "capital interest in a partnership," did not "change[] the law so that a holding of debt (or of an interest overwhelmingly in the nature of debt) could qualify as a partnership interest."

> Notwithstanding that they tend to favor the government's position, the governing statute and regulation leave some ambiguity as to whether the holder of partnership debt (or an interest overwhelmingly in the nature of debt) shall be recognized as a partner. Therefore, we may consult the legislative history to see whether it sheds light on their interpretation. … The reports of the House and the Senate accompanying the passage of § 704(e) make clear that the provision did not intend to broaden the character of interests in partnerships that qualify for treatment as a partnership interest to include partnership debt.
>
> The purpose of the statute was to address an altogether different question. The concern of § 704(e)(1) was whether it matters, for the determination of whether a person is a partner for tax purposes, that the person's purported partnership interest arose through an intrafamily transfer. The section was passed to reject court opinions that refused to recognize for tax purposes transfers of partnership interests because the transfers were effectuated by intrafamilial gift, as opposed to arm's length purchase. Its focus is not on the nature of the investment in a partnership, but rather on who should be recognized for tax purposes as the owner of the interest.

- The Second Circuit went on to describe that District Court as having found that the banks incurred "real risk" that might require them to restore a negative capital accounts, and thus having concluded "that the banks' interest was therefore an 'interest in the assets of the partnership' distributable to them upon liquidation." The Second Circuit then described the District Court's finding that the banks' interest qualified as a capital interest as having been "premised entirely on the significance it accorded to the possibility that the banks would be required to bear 1% of partnership losses exceeding $7 million, or 100% of partnership losses exceeding $541 million." But the Second Circuit disagreed, holding that there was a mere appearance of risk, rather than any real risk, which did not justify treating the banks' interest as a capital, or equity, interest, noting that it had reached the same conclusion in its earlier opinion. The Second Circuit then suggested that "[t]he district court was perhaps reading § 704(e)(1) to mean that the addition to a debt interest of any possibility that the holder's ultimate entitlement will vary, based on the

Back to Table of Contents

debtor's performance, from pure reimbursement plus a previously fixed rate of return will qualify that interest as a partnership interest, no matter how economically insignificant the potential deviation and how improbable its occurrence." The Second Circuit "disagree[d] with any such reading of the statute. No such interpretation is compelled by the plain language of § 704(e)(1). And the fact that the statute was intended to serve an altogether different purpose is confirmed by the legislative reports." The Second Circuit continued:

> In explaining our conclusion that the banks' interest was not a genuine equity interest, we repeatedly emphasized that, as a practical matter, the structure of the partnership agreement confined the banks' return to the Applicable Rate regardless of the performance of Castle Harbour. …
>
> The banks' interest was therefore necessarily not a "capital interest" … . Because the banks' interest was for all practical purposes a fixed obligation, requiring reimbursement of their investment at a set rate of return in all but the most unlikely of scenarios, their interest rather represented a liability of the partnership. … Accordingly, for the same reasons that the evidence compels the conclusion that the banks' interest was not bona fide equity participation, it also compels the conclusion that their interest was not a capital interest within the meaning of § 704(e)(1)

- Turning to the § 6662 penalty issue, the Second Circuit again trashed Judge Underhill's opinion and reversed, reinstating the penalties, stating that Judge Underhill had "mistakenly concluded that several of our decisions supported treatment of the banks as partners in Castle Harbour."

3. Frack the corporate tax for this waste removal partnership. Ltr. Rul. 201227002 (3/1/12, *released* 7/6/12). The IRS concluded in this private letter ruling that income from the removal, treatment, recycling and disposal of waste products from fracturing processes in oil and gas production is qualifying gross income under § 7704(d)(1)(E), permitting a publicly traded partnership to avoid being taxed as an association under § 7704.

4. Section 47 historic rehabilitation credits were allowed to an LLC (taxed as a partnership) in which Pitney Bowes was a 99.9 percent member despite an IRS challenge under the anti-abuse provisions of Reg. § 1.701-2, but it was too late to keep the Miss America Pageant in Atlantic City. Historic Boardwalk Hall, LLC v. Commissioner, 136 T.C. 1 (1/3/11). The Tax Court (Judge Goeke) held that the ownership interest on the historic East Hall of the Atlantic City Boardwalk Hall under a 35-year lease belonging to the New Jersey Sports and Exposition Authority could be transferred to Historic Boardwalk Hall, LLC, in which Pitney Bowes (through a subsidiary and an LLC) was the 99.9 percent member (and the NJSEA was the 0.1 percent member). Along with ownership went the § 47 Federal tax credit of 20 percent of the qualified rehabilitation expenditures incurred in transforming the run-down East Hall from a flat-floor convention space to a "special events facility" that could host concerts, sporting events and other civic events. Pitney Bowes became the 99.9 percent member of Historic Boardwalk Hall, LLC, following an offering memorandum sent to nineteen large corporations, which described the transaction as a "sale" of tax credits (although that description was not repeated in any of the subsequent documents relating to the transaction). NJSEA lent about $57 million to Historic Boardwalk Hall and Pitney Bowes made capital contributions of more than $18 million to that LLC, as well as an investor loan of about $1.2 million. In that offering memorandum, losses were projected over the first decade of operation of East Hall. The IRS argued that the bulk of the Pitney Bowes contributions were paid out to NJSEA as a "development fee" and that the entire transaction was a sham because NJSEA was going to develop East Hall regardless of whether Pitney Bowes made its capital contributions and loan.

- Judge Goeke held that one of the purposes of § 47 was "to encourage taxpayers to participate in what would otherwise be an unprofitable activity," and the rehabilitation of East Hall was a success, leading to the conclusion that Historic Boardwalk had objective economic substance. He also held that Pitney Bowes and NJSEA, "in good faith and acting with a business purpose, intended to join together in the present conduct of a business enterprise" and that while the offering memorandum used the term "sale," "it was used in the context of describing an investment transaction." Finally, Judge Goeke used Reg. § 1.701-2(d), Example (6), involving two high-bracket taxpayers who joined with a corporation to form a partnership to own and operate a building that qualifies for § 42 low-income housing credits, to conclude that Reg. § 1.701-2 did not apply to the Historic Boardwalk transaction because that regulation "clearly contemplate[s] a situation in which a partnership is used to transfer valuable tax attributes from an entity that cannot use them . . . to [a taxpayer] who can . . . ."

- Query whether "economic substance" requirements are applicable when the tax benefits take the form of tax credits enacted to encourage specific types of investments?

a. **"'[T]he sharp eyes of the law' require more from parties than just putting on the 'habiliments of a partnership whenever it advantages them to be treated as partners underneath.' ... Indeed, *Culbertson* requires that a partner '*really and truly intend*[] to … shar[e] in the profits and losses' of the enterprise. ... And, after looking to the substance of the interests at play in this case, we conclude that, because Pitney Bowes lacked a meaningful stake in either the success or failure of Historic Boardwalk Hall, it was not a bona fide partner."** Historic Boardwalk Hall LLC v. Commissioner, ___ F.3d ___ (3d Cir. 8/27/12) In a unanimous opinion by Judge Jordan, the Third Circuit reversed the Tax Court and held that Pitney Bowes was not a bona fide partner in Historic Boardwalk Hall LLC. The court's reasoning was based on the *Culbertson* test [*Commissioner v. Culbertson*, 337 U.S. 733 (1949)], as applied by the Second Circuit in *TIFD III-E, Inc. v. United States*, 459 F.3d 220, 232 (2d Cir. 2006) (*Castle Harbour*), to find that the Dutch banks were not partners and on the reasoning of Fourth Circuit in *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129 (4th Cir. 2011), to find that the investors who acquired the Virginia Historic Rehabilitation credits through the partnership bore no "true entrepreneurial risk," which the Third Circuit concluded was a characteristic of a of a true partner under the *Culbertson* test. The Third Circuit concluded that Pitney Bowes was not a partner because, based on an analysis of the facts, as the transaction was structured, (1) Pitney Bowes "had no meaningful downside risk because it was, for all intents and purposes, certain to recoup the contributions it had made to HBH and to receive the primary benefit it sought– the HRTCs or their cash equivalent," and (2) Pitney Bowes' "avoidance of all meaningful downside risk in HBH was accompanied by a dearth of any meaningful upside potential." The analysis was highly factual and based on substance over form. As for downside risk, the Court of Appeals reversed as clearly erroneous the Tax Court's finding that Pitney Bowes bore a risk because it might not receive an agreed upon 3% preferred return on its contributions to HBH. Referring to *Virginia Historic Tax Credit Fund,* the Third Circuit treated the 3% preferred return as a "return on investment" that was not a "share in partnership profits," which pointed to the conclusion that Pitney Bowes did not face any true entrepreneurial risk. As for upside potential, applying the substance over form doctrine, the court concluded that "although in form PB had the potential to receive the fair market value of its interest ... in reality, PB could never expect to share in any upside." The court noted that it was mindful "of Congress's goal of encouraging rehabilitation of historic buildings." and that its holding might "jeopardize the viability of future historic rehabilitation projects." but observed that it was not the tax credit provision itself that was under attack, but rather the particular transaction transferring the benefits of the credit in the manner that it had.

- The opinion makes it very clear that the decision was based on applying the "substance over form" doctrine rather than the "economic substance" doctrine to determine that Pitney Bowes was not a partner.

B. Allocations of Distributive Share, Partnership Debt, and Outside Basis

1. **DAD follows the Son of Boss into the tax shelter abyss.** Superior Trading, LLC v. Commissioner, 137 T.C. 70 (9/1/11). This case involved a so-called distressed asset/debt (DAD) tax shelter structure created by John Rogers, tax lawyer and purported international finance expert. The court (Judge Wherry) described the structure by noting that, "true to the poet's sentiment that 'The Child is father of the Man,' the DAD deal seems to be

considerably more attenuated in its scope, and far less brazen in its reach, than the Son-of-BOSS transaction." At the top of Rogers' pyramid, Warwick Trading, LLC acquired uncollectable receivables from a bankrupt Brazilian retailer under a contribution arrangement. Warwick claimed a transferred basis in the receivables equal to their face value under § 723. The receivables were then contributed through multiple tiers of trading companies, interests in which were sold to individual investors. Not long after the contribution transaction, the interest of the Brazilian retailer in Warwick was redeemed, but no § 754 election to adjust basis under § 743(b) was made. Ultimately the individual investors claimed loss deductions though their interests in the trading company partnerships as the receivables were liquidated at their depreciated value through an accommodating party. These transactions occurred before the October 2004 revisions to §§ 704(c), 734 and 743 (requiring allocations of built-in loss only to the contributing party, limiting basis to FMV at the time of contribution, and requiring mandatory basis adjustments on distributions involving substantial basis reductions). The court found multiple grounds on which to undo these transactions.

- First, the court held that the original contribution of the receivables was not a partnership transaction under § 721 with § 723 transferred basis, but was instead a sale. The court concluded that the Brazilian retailer was never a partner in a partnership with a joint-profit motive, and thus the transfer of the receivables in the initial transaction was not a § 721 contribution to a partnership.
- The Brazilian retailer's receipt of money within two years of the transfer of the receivables supported recharacterization of the transaction as a sale under § 707(a)(2)(B).
- From the Brazilian retailer's financial statements the court found that the receivables had a zero basis at the time of the contribution in any event.
- And if that was not enough, the court collapsed the transaction under the step-transaction doctrine into a single transaction that consisted of a sale of the receivables for the amount of cash payments eventually made to the Brazilian retailer on redemption of its interest. Thus, Warwick's basis in the receivables was no higher than the cash payment, which the taxpayer failed to substantiate resulting in a zero basis.
- Interestingly, the court concluded that it was not necessary to address the broad judicial economic substance doctrine that other courts had used to disallow the tax benefits of the Son-of-Boss cases. The court said that, "Because of a DAD deal's comparatively modest grab and highly stylized garb, we can safely address its sought-after tax characterization without resorting to sweeping economic substance arguments" and added that, "we need only look at the substance lurking behind the posited form, and where appropriate, step together artificially separated transactions, to get to the proper tax characterization."
- All of that was followed by an accuracy related penalty under § 6662.

2. Partnership debt for equity swaps. Holy Asymmetry! The partners have COD income but the creditor doesn't have a loss deduction. REG-164370-05, Section 108(e)(8) Application to Partnerships, 73 F.R. 64903 (10/31/08). As amended by the American Jobs Creation Act of 2004, § 108(e)(8) provides that for purposes of determining COD income of a partnership, if a debtor partnership transfers a capital or profits interest to a creditor in satisfaction of either recourse or nonrecourse partnership debt the partnership is treated as having satisfied the debt with an amount of money equal to the fair market value of the interest. Any COD income recognized under § 108(e)(8) passes through to the partners immediately before the discharge. Prop. Reg. § 1.108-8 would provide that for purposes of § 108(e)(8), the fair market value of a partnership interest received by the creditor is the liquidation value of that debt-for-equity interest, if: (1) the debtor partnership maintains capital accounts in accordance with Reg. § 1.704-1(b)(2)(iv), (2) the creditor, the debtor partnership, and its partners treat the fair market value of the debt as equaling the liquidation value of the partnership interest for purposes of determining the tax consequences of the debt-for-equity exchange, (3) the debt-for-equity exchange is an arm's-length transaction, and (4) subsequent to the exchange, neither the partnership redeems, nor any person related to the partnership purchases, the creditor's partnership interest as part of a plan that has as a principal purpose the avoidance of COD income by the partnership. If these conditions are not satisfied, all of the facts and circumstances are considered in determining the fair market value of the debt-for-equity interest for purposes of applying § 108(e)(8). Prop. Reg. § 1.721-1(d) would provide nonrecognition of loss in a debt-for-partnership interest exchange in which the liquidation value of the partnership interest is less than the outstanding principal balance of the debt. The creditor's basis in the partnership is determined under § 722. However, the proposed regulations provide that § 721 does not apply to the transfer of a partnership interest to a creditor in satisfaction of a partnership's indebtedness for unpaid rent, royalties, or interest on indebtedness (including accrued original issue discount). In addition, the proposed regulations do not supersede the gain recognition rules of § 453B regarding dispositions of installment obligations. The proposed regulations will be effective when final regulations are published in the Federal Register.

a. **Finalized, with some modifications, but learn to live with the asymmetry.** T.D. 9557, Application of Section 108(e)(8) to Indebtedness Satisfied by a Partnership Interest, 76 F.R. 71255 (11/17/11). The final regulations generally are the same as the proposed regulations, with certain modifications.

(1) First, Reg. § 1.108-8(b)(2)(i)(B) requires as a condition to the liquidation value safe harbor that a partnership apply a consistent valuation methodology to all equity issued in any debt-for-equity exchange that is part of the same overall transaction. This prevents selective exploitation of the discrepancy between liquidation value and fair market value.

(2) Second, Reg. § 1.108-8(b)(2)(i)(C) clarifies that the arm's length transaction requirement for the liquidation value safe harbor is available to a transaction involving related parties as long as the debt-for-equity exchange has terms that are comparable to terms that would be agreed to by unrelated parties negotiating with adverse interests.

(3) Third, for the anti-abuse provision [condition (4) in the proposed regulations, *supra*] "related" party is defined by cross-references to §§ 267(b) and 707(b); Reg. § 1.108-8(b)(2)(i)(D).

(4) Fourth, the liquidation value of an interest in an upper-tier partnership is determined by taking into account the liquidation value of any lower-tier partnership interest; Reg. § 1.108-8(b)(2)(ii).

(5) Fifth, Reg. § 1.108-8(b)(1) provides that if the fair market value of the debt-for-equity interest does not equal the fair market value of the indebtedness exchanged, then general tax law principles shall apply to account for the difference. The preamble notes that, if appropriate, § 707(a)(2)(A) can be applied.

(6) Sixth, Reg. § 1.721-1(d)(2) provides that § 721 does not apply to a debt-for-equity exchange to the extent the partnership interest is exchanged for the partnership's indebtedness for unpaid rent, royalties, or interest on the partnership's indebtedness (including accrued OID) that accrued on or after the beginning of the creditor's holding period for the indebtedness.

(7) Seventh, the final regulations provide that COD income arising from a discharge of a partnership or partner nonrecourse indebtedness is treated as a first-tier item for minimum gain chargeback purposes under Regs. §§ 1.704-2(f)(6), 1.704-2(j)(2)(i)(A) and 1.704-2(j)(2)(ii)(A); Reg. § 1.704-2(f)(6).

3. **Only in tax law could insolvency result from debts you don't really have to repay.** Rev. Rul. 2012-14, 2012-24 I.R.B. 1012 (5/25/12). Section 108(a)(1)(B) excludes COD from gross income if the cancellation occurs when the taxpayer is insolvent; § 108(a)(3) limits the amount of COD income excluded by § 108 to the amount by which the taxpayer is insolvent. Rev. Rul. 92-53, 1992-2 C.B. 48, provides that the amount by which a nonrecourse debt exceeds the fair market value of the property securing the debt ("excess nonrecourse debt") is treated as a liability in determining insolvency for purposes of § 108 to the extent that the excess nonrecourse debt is discharged. Revenue Ruling 2012-14 holds that for purposes of measuring a partner's insolvency under § 108(d)(3), each partner treats as a liability an amount of the partnership's discharged "excess nonrecourse debt" that is based upon the allocation of COD income to such partner under § 704(b) and the regulations thereunder.

Back to Table of Contents

4. Retention of an economic interest is not a liquidation. Brennan v. Commissioner, T.C. Memo. 2012-209 (7/23/12). Ashland and Brennan were members of the Cutler LLC, which managed asset portfolios for high-income individuals. (Another Cutler case is discussed under the partnership audit rules at VII.F.7., below.) Ashland was the CEO of Cutler. Cutler was restructured in 2002 because of "turmoil" among the members. Cutler sold certain institutional accounts under an agreement entered into in 2002, with payments made in 2003 and 2004. Sales proceeds were used to satisfy Cutler liabilities and obligations. At the time of the sale Brennan ceased to be a member of Cutler, but continued to hold "an economic interest" which conferred a continuing interest in income and loss items. Ashland reported capital gain from the sale in 2003, but none in 2004. Brennan reported no capital gain from the Cutler sale. The IRS asserted inconsistent deficiencies against both Ashland and Brennan in order to avoid a whipsaw, asserting in that Ashland was responsible for reporting all of the capital gains recognized in 2003 and 2004 and that Brennan was responsible for reporting his 45 percent distributive share of the capital gains. The Tax Court (Judge Kroupa) rejected Brennan's claim that his partnership interest terminated in 2002, holding that a retiring partner remains a partner for tax purposes until the partner's interest has been completely liquidated. Thus, the court held that Brennan was responsible for reporting his share of partnership capital gain derived in 2003 and 2004. Ashland was responsible for reporting her share of the capital gain as set forth in the 2002 restructuring agreement.

C. Distributions and Transactions Between the Partnership and Partners

1. De minimis partners become substantial under proposed regulations. REG-109564-10, Partner's Distributive Share, 76 F.R. 66012 (10/25/11). The economic effect of a partnership allocation is not substantial under Reg. § 1.704-1(b)(2)(iii)(*a*) if, at the time the allocation (or allocations) becomes part of the partnership agreement: (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement. Reg. § 1.704-1(b)(2)(iii)(*e*) provides that the tax attributes of a de minimis partner (a partner who owns less than 10 percent of partnership capital or profits) need not be taken into account in applying the substantiality tests. The proposed regulation would remove the de minimis partner rule "in order to prevent unintended tax consequences." The preamble to the proposed regulation indicates that the de minimis partner rule was "not intended to allow partnerships to entirely avoid the application of the substantiality regulations if the partnership is owned by partners each of whom owns less than 10 percent of the capital or profits, and who are allocated less than 10 percent of each partnership item of income, gain, loss, deduction, and credit." The regulations will be effective when finalized.

D. Sales of Partnership Interests, Liquidations and Mergers

E. Inside Basis Adjustments

F. Partnership Audit Rules

1. Partner's outside basis in a tax-shelter partnership is a partner item. Napoliello v. Commissioner, T.C. Memo. 2009-104 (5/18/09). The taxpayer invested in a Son-of-Boss transaction involving digital foreign currency items. The IRS issued an FPAA to the taxpayer as a notice partner. In the uncontested partnership proceeding it was determined that the partnership was a sham that lacked economic substance, that transactions entered into by the partnership should be treated as transacted directly by the partners, and that purported losses claimed on disposition of distributed property with an enhanced basis should be disallowed. The IRS assessed a deficiency against the taxpayer based on the partnership items. The Tax Court previously had held in *Petaluma FX Partners, LLC v. Commissioner*, 131 T.C. 84 (2008), that the determination of whether a partnership was a sham that will be disregarded for Federal tax purposes is a partnership item. In the instant case, the court (Judge Kroupa) agreed with the IRS that the partner's basis in distributed securities from the sham partnership is an affected item subject to determination in the partnership proceeding, and not subject to re-determination in the partner-level deficiency proceeding. Because the amount of any loss with respect to the partner's disposition of securities distributed from the partnership required a factual determination at the partner level, the court held that it had jurisdiction in the partner deficiency proceeding to proceed under normal deficiency procedures. The court thus proceeded to determine that the taxpayer's claimed loss on the sale of the distributed securities was disallowed, that the taxpayer's basis in the securities was their direct cost rather than an exchange basis from the partnership interest, and that the taxpayer was not allowed to deduct transaction costs attributable to the investment. The Tax Court also held that the FPAA gave the taxpayer fair notice of the IRS claims.

a. **Part of the Tax Court's holding in *Petaluma FX* Partners retains its vitality, but not the part the Tax Court relied upon in *Napoliello*.** Petaluma FX Partners, LLC v. Commissioner, 591 F.3d 649 (D.C. Cir. 1/12/10). The Tax Court in this Son-of-Boss tax shelter case determined that it had jurisdiction in a TEFRA partnership proceeding to determine that the partnership lacked economic substance and was a sham. Since the partnership was disregarded, the Tax Court concluded that it had jurisdiction to determine that the partners' outside basis in the partnership was zero. The Tax Court reasoned that a partner could not have a basis in a partnership interest that did not exist. (131 T.C. 84 (2008)) The Court of Appeals agreed that the Tax Court had jurisdiction in the partnership proceeding to determine that the partnership was a sham. Temp. Reg. § 301.6223-1T(a) expressly provides that "[a]ny final partnership administrative adjustment or judicial determination ... may include a determination that the entity is not a partnership for such taxable year." The Court of Appeals held that the regulation was explicitly authorized by § 6233. A partnership item is defined in § 6231(a)(3) as an item required to be taken into account in determining the partnership's income under Subtitle A of the Code that is identified in regulations as an item more appropriately taken into account at the partnership level. The court indicated that, "Logically, it makes perfect sense to determine whether a partnership is a sham at the partnership level. A partnership cannot be a sham with respect to one partner, but valid with respect to another." However, the Appeals Court concluded that the partners' bases were affected items, not partnership items, and that the Tax Court did not have jurisdiction to determine the partners' bases in the partnership proceeding. The court rejected the IRS argument that the Tax Court had jurisdiction in the partnership proceeding to determine the partners' outside basis as an affected item whose elements are mainly determined from partnership items. The court held that resolution of the affected item requires a separate determination at the partner level even though the affected item could easily be determined in the partnership proceeding. Finally, the Court of Appeals held that accuracy related penalties under § 6662(a) could not be determined without a determination of the partners' outside basis in a partner level proceeding and vacated and remanded the Tax Court's determination of penalty issues.

b. **On remand, the Tax Court disavowed jurisdiction over penalties in the partnership-level proceeding.** Petaluma FX Partners, LLC v. Commissioner, 135 T.C. 581 (12/15/10). The court (Judge Goeke) held that in light of the Court of Appeals holding that determination of adjustments attributable to the partner's outside basis is an affected item properly addressed in individual partner level proceedings, any § 6662 penalties must also be determined at the partner-level proceeding and that the Tax Court had no jurisdiction to assess the penalties. The court rejected the IRS argument that the penalties proceeded from the partner-level determination that the partnership was a sham, thereby providing jurisdiction for the Tax Court to determine the negligence penalty. The Tax Court held that if a penalty "does not relate directly to a numerical adjustment to a partnership item, it is beyond our jurisdiction. In this case there are no such adjustments to which a penalty can apply." Judge Halpern dissented, asserting that the Tax Court could reconsider the penalty on grounds other than the partners' outside bases under the court's initial findings that the partnership was a sham and did not provide the basis increase claimed by the partners. A dissent by Judge Marvel (joined by three others) argued that the Tax Court has jurisdiction to determine the imposition of a penalty for negligence related to adjustment of a partnership item in the partnership level proceeding, but the amount of the individual penalty depends upon a computation at the partner level.

c. Partner's outside basis in a tax-shelter partnership is a partner item. Napoliello v. Commissioner, 655 F.3d 1060 (9th Cir. 8/23/11). The taxpayer invested in a Son-of-Boss transaction involving digital foreign currency items. The IRS issued an FPAA to the taxpayer as a notice partner. In the uncontested partnership proceeding it was determined that the partnership was a sham that lacked economic substance, that transactions entered into by the partnership should be treated as transacted directly by the partners, and that purported losses claimed on disposition of distributed property with an enhanced basis should be disallowed. The IRS assessed a deficiency against the taxpayer based on the partnership items. Upholding the Tax Court, the Ninth Circuit joined the D.C and Eighth Circuits, *Petaluma FX Partners, LLC v. Commissioner*, 591 F.3d 649 (D.C. Cir. 2010); *RJT Invs. X v. Commissioner*, 491 F.3d 732 (8th Cir. 2007), holding that the determination of whether a partnership was a sham that will be disregarded for Federal tax purposes is a partnership item. The Ninth Circuit also agreed with the Tax Court that the partner's basis in distributed securities from the sham partnership is an affected item subject to determination in the partnership proceeding, and not subject to re-determination in the partner-level deficiency proceeding. Because the amount of any loss with respect to the partner's disposition of securities distributed from the partnership required a factual determination at the partner level, the court held that the Tax Court had jurisdiction in the partner deficiency proceeding to proceed under normal deficiency procedures. Thus, the Tax Court could determine that the taxpayer's claimed loss on the sale of the distributed securities was disallowed, that the taxpayer's basis in the securities was their direct cost rather than an exchange basis from the partnership interest, and that the taxpayer was not allowed to deduct transaction costs attributable to the investment.

d. Disregarded tax-shelter partnership is still a partnership for purposes of the TEFRA audit rules. Tigers Eye Trading LLC v. Commissioner, 138 T.C. No. 6 (2/13/12) (reviewed, court opinion joined by 5 judges, 3 judges concurred and 4 dissented). In this Son of BOSS tax shelter matter the parties stipulated that the tax shelter partnership should be disregarded, the basis of distributed property should be reduced to zero, and upheld accuracy related penalties. The partnership filed a motion to revise the stipulated decision after the D.C. Circuit's decision in *Petaluma FX Partners, LLC v. Commissioner*, 591 F.3d 649 (D.C. Cir. 2010), which held that a partner's outside basis is not a partnership item subject to the court's jurisdiction in a partnership-level proceeding and thus not subject to a penalty determination in the partnership proceeding. In an opinion joined by only Judges Colvin, Halpern (who also wrote a separate concurring opinion), Cohen, and Goeke, the Tax Court (Judge Beghe) held that it has jurisdiction in a partnership-level proceeding against an entity that filed a partnership return to determine whether the entity should be disregarded as a partnership and to determine all items of the entity that would be partnership items if the entity had been a partnership, citing §§ 6233 and 6226(f) and Temp. Reg. § 301.6226(f)-1T. Under § 6233 if a partnership return is filed for a taxable year but it is determined that no partnership exists, the TEFRA procedures apply to the partnership, partnership items and to persons holding an interest in the entity. The court specifically noted that a holding that an entity does not exist under Temp. Reg. § 1.6233-1T(a) "will serve as a basis for a computational adjustment reflecting the disallowance of any loss or credit claimed by a purported partner with respect to that entity." The court indicated that *Petaluma FX Partners* was decided on the basis of a government concession that outside basis was not a partnership item. The court held that under *Mayo Foundation for Med. Educ. & Research v. United States*, 562 U.S. ___, 131 S. Ct. 704 (2011), decided subsequent to *Petaluma FX Partners,* it was required to defer to the regulations. The court then interpreted the basis rules of subchapter K and Reg. § 301.6231(a)(3)-1(a) to require that determination of outside basis is a partnership item:

> Determination of the partners' outside bases in their interests in a partnership that is recognized for Federal income tax purposes requires complex determinations of not only the amounts of partnership items that are elements of outside basis but

also the partners' shares of those amounts, which are also partnership items. Those complex determinations must be made in the partnership proceeding, and most often there are no other factors to be determined at the partner level.

- With respect to its jurisdiction to assess penalties, unlike the D.C. Circuit in *Petaluma FX Partners*, the court indicated that, based on its holding that the partners' outside bases were subject to determination in the partnership-level proceeding, the court had jurisdiction to impose the 40 percent basis misstatement penalty at the partnership level.

- Judge Wherry wrote a concurring opinion. Judges Gale and Paris concurred in the result only, without opinions. Judge Marvel wrote a dissent, which was joined in part by Judges Thornton and Kroupa. Judge Foley dissented without opinion, and Judges Vasquez, Gustafson and Morrison did not participate.

- Since this case is appealable to the D.C. Circuit, the Tax Court's lengthy opinion is not likely to be the last word.

e. Partnership items are in the eye of the beholder. Petaluma FX Partners v. Commissioner, T.C. Memo. 2012-142 (5/17/12). On its own motion, the D.C. Circuit again remanded this case back to the Tax Court to reassess the Tax Court's holding in *Petaluma III* (135 T. C. 581) that it lacked jurisdiction to determine the partner's outside basis in the partnership proceeding because it is an affected item in light of the court's majority decision in *Tigers Eye Trading LLC v. Commissioner*, 138 T.C. No. 6 (2/13/12), that it had jurisdiction in the partnership level proceeding to determine the partner's outside bases and assess penalties. *Petaluma FX Partners v. Commissioner*, 109 A.F.T.R. 2d 2012-2238 (Unpublished Op. D.C. Cir. 2/27/12). The Circuit Court cited the lone dissent by Judge Holmes where he stated that, "Our decision today overrules *Petaluma III*". In its supplemental memorandum decision the court (Judge Goeke) indicated that the decision on remand in *Petaluma* was based on the "narrow" instruction on remand from the DC Circuit which established the law of the case and further stated that its decision on remand was "thoroughly imbued with the legal reasoning and logic provided by the D.C. Circuit in its earlier decision." The court also stated that the language from Judge Holmes dissent in *Tigers Eye* that was cited in the D.C. Circuit's remand does not represent the position of the court and indicated that no part of the opinion in *Tigers Eye* "purported to explicitly alter or overrule the decision in this case or to revise the language of the Court's Opinion in *Petaluma III*."

2. Son-of-Boss sham partnership determination, partner's basis, and liability for penalties are not affected items over which the Tax Court has jurisdiction in a partner proceeding. Thompson v. Commissioner, 137 T.C. 220 (12/27/11) (reviewed). The taxpayer invested in a Son-of-Boss transaction through a partnership. In a final partnership proceeding affirmed by the Eighth Circuit, the court determined that the partnership was a sham, that there was no basis in a partnership interest, and that the partnership was subject to a 40 percent accuracy penalty. *RJT Invs. X, LLC v. Commissioner*, 491 F.3d 732 (8th Cir. 2007). The IRS thereafter issued an affected item notice of deficiency to the taxpayer for the deficiency attributable to the partnership action and to collect the penalty. On the following day, the IRS directly assessed the deficiency and the penalty amount as a computational item based on the partnership proceeding, not requiring a notice of deficiency. The taxpayer filed a petition with the Tax Court to set aside the deficiency. The IRS responded that the notice of deficiency was invalid and that the Tax Court lacked jurisdiction in the case on the ground that no valid statutory notice of deficiency had been sent to the taxpayers. The Tax Court (Judge Wherry) held for the IRS with two dissents. The court held that assessing the deficiency based on the final partnership proceeding did not require any partner level determinations and thus was not subject to deficiency procedures. The court rejected the taxpayer's argument that under *Petaluma FX Partners, LLC v. Commissioner*, 591 F.3d 649 (D.C. Cir. 2010), *aff'g in part, rev'g in part and remanding in part* 131 T.C. 84 (2008), an accuracy related penalty does not relate to adjustment of a partnership item and can be assessed only in a partner proceeding. The court held that the accuracy related penalty can be directly assessed and is not subject to deficiency procedures, notwithstanding the need for partner-level determinations. The court also held that the fact that the IRS's direct assessment contained errors that required correction resulting in a reduction of the deficiency did not make the assessment a determination that required a notice of deficiency under § 6212(a). The majority determined that all of the four items in the notice of deficiency followed directly from the treatment of the partnership as having no profit motive and were thus computational. Judge Goeke dissented on the question of subject matter jurisdiction asserting that, even though the taxpayer and the IRS resolved the factual issues presented in the notice of deficiency, the determination of partner level losses requires a partner-level determination subject to a notice of deficiency. Judge Holmes argued that the multiple adjustments asserted in the notice of deficiency involved partner-level determinations that went beyond the adjustments that directly resulted from the partnership level proceeding, including the taxpayer's claimed loss on liquidation of the partnership, which Judge Holmes concluded was an item one-step removed from the partnership level determination. Judge Holmes' dissent expressed a concern that the rejection of jurisdiction will require a case-by-case assessment of whether a computational adjustment will involve a partner level determination.

3. Who settled with whom and when? Mathia v. Commissioner, 109 A.F.T.R.2d 2012-375 (10th Cir. 1/5/12). The taxpayer's deceased husband was a partner in a Swanton Coal partnership that the IRS challenged with an FPAA. In 1991 the law firm representing the tax matters partner entered into a settlement agreement in principle, but which required further negotiation with the IRS to determine the settlement amount. In 1995 the IRS sent a stipulation of settlement agreement to the partnership that was signed by the partnership but not by the IRS. An identical agreement was signed by both parties in 2001 and entered as a final judgment by the Tax Court. Within the one year allowed from the date of final judgment under § 6225(a), the IRS issued a deficiency assessment against the taxpayer, who asserted that the earlier settlements represented a settlement with individual partners that reclassified the claimed partnership losses as nonpartnership items under § 6231(b)(1)(C), which then required an assessment within one year of the settlement. The court held that even if the 1991 agreement in principle and the subsequent settlement were binding agreements, the agreements dealt only with partnership items and not settlement agreements with individual partners. Thus, the taxpayer was not dismissed from the partnership level proceeding and the assessment within one year of the final Tax Court judgment was timely.

4. Keep those addresses up to date. International Strategic Partners, LLC v. Commissioner, 109 A.F.T.R.2d 2012-569 (2d Cir. 1/19/12). In a nonprecidential summary order, the court affirmed the Tax Court's dismissal of a petition filed more than 150 days after the IRS mailed an FPAA. The court held that the IRS met the § 6223(a) notice requirements by mailing the notices to the LLC at the address shown on its tax return and to the partners at the addresses shown on accompanying Schedules K-1. The IRS was not required to do more when the LLC failed to provide the IRS with additional information. The taxpayer is responsible for updating contact information under § 6223(c)(2) and Reg. § 301-6223(c)-1.

5. The TEFRA audit rules create a mess with tiered partnerships. Rawls Trading L.P. v. Commissioner, 138 T.C No. 12 (3/26/12). The ultimate taxpayer, Jerry Rawls, entered into Son of BOSS transactions using a tiered partnership structure. The proceeds of short sales of Treasury notes were contributed to lower-tier partnerships by various trust entities (referred to by the court as source partnerships). In turn, the partnership interests in the lower tier partnerships with inflated basis, were contributed to middle partnerships (referred to by the court as interim partnerships). The interim partnership passed through losses generated by transactions using the inflated basis of the source partnerships. The "contrived losses" eventually inured to the tax benefit of Rawls. The IRS issued FPAA's to both the source and interim partnerships. The court (Judge Vasquez) ultimately concluded that since any determination of a deficiency in the interim partnership required resolution of the FPAA issued to the source partnership, such a deficiency was based on a computational adjustment to the interim partnership as a partner, or on resolution of an affected item. In either case, the court held that it lacked jurisdiction to consider the FPAA issued to the interim partnership and dismissed the FPAA. The court rejected the IRS request to stay the proceeding with respect to the interim partnership as premature until the issues in the source partnership proceeding were resolved. The court indicated that since it had no jurisdiction to consider the FPAA issued to the interim partnership, it had no jurisdiction to stay the proceeding. The court also addressed the IRS's assertion that it would be barred from issuing a second FPAA to the interim partnership by the no-second-notice rule of § 6223(f) by pointing out that the court's jurisdiction is conferred by statute ant that it had no option to grant the stay. The court suggested, however, that to the extent that adjudication of the shelter issues in the FPAA issued to the source partnership results in a computational adjustment, the IRS could make a direct assessment against Rawls as an indirect partner (§ 6231(a)(2)) without the need for an FPAA against the interim partnership.

6. TEFRA audit rules bar Tax Court consideration of a guaranteed payment of a small partnership with a pass-through member. Brennan v. Commissioner, T.C. Memo. 2012-187 (7/9/12). In consolidated cases, the Tax Court (Judge Kroupa) determined that it lacked jurisdiction under the TEFRA audit rules to determine whether the taxpayers were entitled to flow-through losses attributable to guaranteed payments. The involved parties were members of the Cutler LLC, which managed asset portfolios for high-income individuals. Ashland was the CEO of Cutler. Ashland and Brennan transferred their Cutler interests to a general partnership, Airport Plaza (AP), which was to dissolve under its own terms at the end of 2001. The Cutler operating agreement in 2002 identifies AP as a Cutler member. Cutler was restructured in 2002 because of "turmoil" among the members. AP's 2002 partnership return claimed a partnership loss for 2002 attributable to a guaranteed payments to Brennan of $4,785,616 and one Joseph Furey a former Cutler member, of $485,000. Ashland claimed her share of the loss from AP on her 2002 return. In a petition contesting the IRS disallowance of the loss, Ashland asserted in an amended petition to the court that the guaranteed payments were in fact made by Cutler and that Ashland was entitled to a pass-through loss from Cutler for the payments. The Cutler 2002 partnership return, signed by Ashland as CEO, reported the payments as guaranteed payments to Brennan and Furey. The court agreed with the IRS that Cutler was a TEFRA partnership so that the status of guaranteed payments by Cutler was a partnership item, determinable only in a TEFRA proceeding. A petition for administrative adjustment of Cutler's 2002 return was barred by the statute of limitations. The court rejected the taxpayer's assertion that Cutler was a small partnership (less than ten members) because the small partnership exception does not apply under § 6231(a)(9) to a partnership that has a pass-through entity as a member. The court did not allow Ashland to disregard her chosen form of operating AP as a partnership and reporting partnership returns. In addition the court found that AP was treated a member of the Cutler LLC in spite of Ashland's argument that Cutler membership interests were never formally transferred to AP because of stipulations by Ashland to the contrary and the Cutler operating agreement unambiguously including AP as a member.

7. A Notice of Deficiency relating to the partner level loss limitation rules need not wait for an FPAA. Meruelo v. Commissioner, 110 A.F.T.R.2d 2012-5207 (9th Cir. 8/16/12). The taxpayer reported losses from a single-member LLC that was a partner in a partnership reporting losses from foreign currency transactions, Intervest. Neither the Intervest returns nor the taxpayer's individual returns identified the status of the disregarded LLC. Although the IRS was investigating Intervest for fraud and there was a related grand jury proceeding, the IRS did not notify the Intervest that it would begin an audit, nor did it issue an FPAA for the year at issue. The IRS issued a notice of deficiency to the taxpayers shortly before the three-year statute of limitations would have expired with respect to their individual returns. Affirming the Tax Court, 132 T.C. 355 (6/9/09), the Court of Appeals (Judge N.R. Smith) held that even though application to a partner of the loss limitation rules of §§ 704(d) and 465 are affected items that require a partner-level determination, a notice of deficiency to a partner based on the application of the loss limitation rules of §§ 704(d) and 465 was not issued prematurely and was valid. The Tax Court had jurisdiction over the petition. While the TEFRA audit rules require completion of partnership proceedings when a partnership item or a related item is involved before issuing a notice of deficiency to partners, the court held that TEFRA does not limit the issuance of a notice of deficiency when no partnership proceeding is pending and no notice of deficiency has been sent. The court also stated that although § 6225(a) provides that "no assessment of a deficiency attributable to any partnership item may be made ... before" 150 days after the date a notice of FPAA is mailed or a proceeding in Tax Court has been finalized, assessment of a deficiency is not the same as providing a notice of deficiency. The court also rejected the taxpayer's argument that the notice of deficiency was improper when issued because the IRS was considering a criminal investigation that might have found fraud. The court held that the IRS's contemplation of initiating future proceedings is irrelevant and that requiring the IRS to prove that it had no interest in future partnership-level proceedings would serve no purpose.

8. **Asset management joint venture is not a partnership, so take that ordinary income.** Rigas v United States, 107 A.F.T.R.2d 2011-2046 (S.D. Tex. 5/2/11). Hydrocarbon Capital, LLC, which held a number of oil and gas industry financial assets, entered into a loan management and servicing agreement (specifically stating the arrangement was not a partnership) with Odyssey Energy Capital I, LP, formed by five individual limited partners with an LLC general partner. The management agreement provided for a performance fee representing 20 percent of profits after provisions for disposition of income realized on the asset portfolio designed to recoup Hydrocarbon's expenses, the capital value of the portfolio and a 10 percent preferred return. In a claim for refund, the taxpayer, one of Odyssey's limited partners, claimed pass-through capital gain treatment on gains from disposition of the managed assets. The District Court (Judge Ellison) agreed with the IRS determination that the income to the Odyssey partners was ordinary income as a service fee rather than pass-through partnership income from a joint venture with Hydrocarbon. The court indicated that notwithstanding the unambiguous text of the management agreement eschewing partnership status, it may still look to the conduct of the parties to determine whether the arrangement was a partnership. The court indicated that the Odyssey partners contributed both capital and services to the relationship with Hydrocarbon, and the arrangement provided for a profit sharing and some risk of loss for the Odyssey partners, which supported treating the arrangement as a partnership. Odyssey maintained significant management responsibility for the Hydrocarbon assets, but it did not have authority to withdraw funds from Hydrocarbon bank accounts, it could not increase Hydrocarbon's capital commitment to a particular asset, it could not enter into binding agreements in Hydrocarbon's name, and it could not dispose of an asset without Hydrocarbon's written approval. Odyssey did not share control over bank accounts that corresponded to companies in the asset portfolio, nor could it disburse funds from the accounts, and thus lacked control over the assets and income of the venture. Finally, the court pointed to the fact that neither Hydrocarbon nor Odyssey filed tax returns treating the arrangement as a partnership. Thus, the court found that the IRS established by a preponderance of the evidence that a partnership did not exist.

- The court also held that it had jurisdiction to consider the taxpayer's refund claim under TEFRA as a partner item based on its holding that the taxpayers' amended returns qualified as a partner Administrative Adjustment Request as being in substantial compliance with the requirements of Reg. § 301.6227(d)-1, notwithstanding the absence of a timely filed form 8802 as required by the regulations.

a. **The Fifth Circuit reverses the District Court but the taxpayer still loses. This case proves that the TEFRA audit rules are ridiculously complicated and result in a Catch-22.** Rigas v. United States, 110 A.F.T.R.2d 2012-5220 (5th Cir. 8/21/12). The taxpayer was one of five limited partners in Odyssey Energy Capital I, LP (Odyssey), which entered into a loan management and servicing agreement with Hydrocarbon Capital, LLC. The agreement provided for a performance fee representing 20 percent of profits after provisions for disposition of income realized on the asset portfolio designed to recoup Hydrocarbon's expenses, the capital value of the portfolio and a 10 percent preferred return. The agreement specifically stated that the arrangement was not a partnership. In 2004 Hydrocarbon recognized approximately $110 million of gain on disposition of assets and paid a performance fee to Odyssey of approximately $20 million. Odyssey originally reported the $20 million as a management fee constituting ordinary income and the Odyssey partner's reported their share of the ordinary income on individual returns. Subsequently Odyssey filed an amended return claiming it was in a partnership with Hydrocarbon and its $20 million share of proceeds was capital gains. The partners filed amended individual returns claiming refunds. Apparently the

IRS allowed refunds to four partners, but denied Rigas' claim. In Rigas' refund suit the District Court held that there was no partnership between Odyssey and Hydrocarbon and the fees paid to Odyssey were properly treated as ordinary income. *Rigas v United* States, 107 A.F.T.R.2d 2011-2046 (S.D. Tex. 5/2/11). The District Court also held that it had jurisdiction to consider the taxpayer's refund claim under TEFRA as a partner item based on its holding that the taxpayers' amended returns qualified as a partner Administrative Adjustment Request as being in substantial compliance with the requirements of Reg. § 301.6227(d)-1, notwithstanding the absence of a timely filed form 8802 as required by the regulations. With a complicated meander through the limitations on filing refund actions by partners under TEFRA, the Fifth Circuit in a lengthy per curiam opinion reversed the District Court's holding that it had jurisdiction to hear the refund action, denied the taxpayer's claim that he was entitled to consideration of whether the partnership item was capital gain, held that the District Court had jurisdiction to determine whether the taxpayer was given inconsistent settlement treatment, but alas concluded that there was no settlement.

- Section 7422(h) bars jurisdiction to consider a refund claim by a partner attributable to partnership items except as provided in §§ 6228(b) or 6230(c). Section 6228(b) allows a refund suit attributable to partnership items if the IRS responds to a partner's Administrative Adjustment Request (AAR), filed as provided in § 6227(d), by mailing a notice indicating that partnership items will be treated as non-partnership items, or if the IRS fails to allow the AAR and no notice is mailed. Section 6230(c) provides for claims arising from erroneous computations and was not at issue in the case. The Court of Appeals rejected the District Court holding that the taxpayer's filing an amended return was substantial compliance with the AAR requirement. The court held that the requirements of Reg. § 301.6627(d)-1 that the taxpayer file a specific form (Form 8082) is a procedural requirement that may be met with substantial compliance, but that the requirement that the taxpayer provide a detailed explanation of the claim is a substantive requirement that must be satisfied so that the IRS can properly whether to allow the AAR. The court held that Rigas' amended return failed to meet the substantive requirements because it had not been filed in the Service Center where the partnership return had been filed, and it did not provide a detailed explanation of the claim for refund.

- The court held that a partner's claim to settlement terms consistent with the terms of a settlement between the IRS and another partner under § 6224(c)(2) is an item that depends upon whether the particular partner has been properly offered consistent settlement terms and is, therefore, not a partnership item. Thus, the court has jurisdiction to consider a refund claim on that basis. However, the court concluded that as a matter of law the IRS' payment of refunds to the other Odyssey partners were not settlement agreements under § 6224 because there was no partnership-level administrative proceeding.

- Finally, the court rejected the taxpayer's alternate claim that since the character of the income was adjusted at the partnership level in the partnership amended return, the taxpayer is entitled to tax treatment consistent with the treatment of the partnership item. The court held that the District Court lacked jurisdiction to consider a refund claim on this basis under § 7422(h) because when the taxpayer "claim that the Performance Fee was recharacterized as capital gains instead of ordinary income at the partnership level and that they are entitled to a refund based on a similar characterization at the partner level, their claim is attributable to a partnership item." The court noted in support of its finding that the item is a partnership item that characterization of the performance fee at the partnership level affects both the partnership's reporting and the reporting of the other partners.

G. Miscellaneous

1. Electronic K-1s. Rev. Proc. 2012-10 (2/13/12). The IRS has provided procedures for furnishing Schedule K-1s to persons to whom a partnership is required to provide the form in an electronic format. The Rev. Proc. notes that the recipient entitled to a K-1 must affirmatively consent to receive the form in electronically, and that the consent may be conveyed electronically.

Back to Table of Contents

2. Tax refunds in a bad economy set up another deference conflict among the circuits. In Re Quality Stores, Inc., 110 A.F.T.R.2d 2012-5253 (6th Cir. 9/7/12). In November 2001 Quality Stores closed 63 stores and 9 distribution centers and terminated the employment of all employees in the course of Chapter 11 bankruptcy cases. Quality Stores adopted plans providing severance pay to terminated employees. The company reported the severance pay as wages for withholding and employment tax purposes then filed claims for refund of FICA and FUTA taxes claiming that the severance pay represented supplemental unemployment compensation benefits (SUBs) that are not wages for employment tax purposes. Disagreeing with the contrary holding by the Federal Circuit in *CSX Corp. v. United States* , 518 F.3d 1328 (Fed. Cir. 2008), the Sixth Circuit held that the SUBs were exempt from employment taxes. The court examined the language and legislative history of § 3402(o)(1), which provides that SUB payments "*shall be treated* as if it were a payment of wages" for withholding purposes, to conclude that by treating SUB payments as wages for withholding Congress recognized that SUB payments were not otherwise subject to withholding because they did not constitute "wages." Then, under *Rowan Cos. v. United States*, 452 U.S. 247, 255 (1981), the court concluded that the term "wages" must carry the same meaning for withholding and employment tax purposes. Thus, if SUBs are not wages under the withholding provision (because the must be treated as wages by statutory directive), the SUBs are not wages for employment tax purposes. The court also rejected the IRS's position in Rev. Rul. 90-72, 1990-2 C.B. 211, that to be excluded from employment taxes SUBs must be part of a plan that is designed to supplement the receipt of state unemployment compensation. The court declined to follow the Federal Circuit's holding in *CSX Corp.*, which adopted the eight part test of Rev. Rul. 90-72, stating that, "We decline to imbue the IRS revenue rulings and private letter rulings with greater significance than the congressional intent expressed in the applicable statutes and legislative histories." The court also stated that it could not conclude that the opinion in *Mayo Foundation for Medical Education & Research v. United States*, 131 S. Ct. 704 (2011), eroded the holding of *Rowan Cos. v. United States*, which compelled the court to interpret the meaning of "wages" the same for withholding and employment tax purposes.

- Will the disagreement between the Federal and Sixth Circuits once again invite the Supreme Court to enter the deference fray?

3. Hiding abusive shelter transactions behind disregarded entities makes the indirect partner an unidentified partner for statute of limitations purposes. Gaughf Properties L.P. v. Commissioner, 139 T.C. No. 7 (9/10/12). The taxpayers invested in KPMG/Jenkens & Gilchrist currency options tax shelters through a partnership consisting of two disregarded LLCs and a wholly owned corporation. After the IRS caught up with the taxpayers from information obtained through John Doe summons issued to Jenkens & Gilchrist, the IRS asserted that the statute of limitations remained open with respect to the taxpayers under § 6229(e), which extends the limitation period for one year after the name and address of a partner is furnished to the IRS where (1) the name address and TIN of the partner is not "furnished" on the partnership return and the IRS has sent notice of an FPAA within the statute of limitations, or (2) the taxpayer has taken an inconsistent position and fails to provide the notice required by § 6222(b). The Tax Court (Judge Goeke) held that the statute remained open under both provisions. Following the holding in *Costello v. United States*, 765 F. Supp. 1003 (C.D. Cal. 1991), the court held that, although Schedule K-1s are required only for direct partners, an indirect partner who is not identified on a partnership return remains an "unidentified partner" for purposes of § 6229(e)(1). The court rejected the taxpayer's argument that because the IRS was in possession of identifying information from applications for taxpayer identification numbers for the disregarded entities (Forms SS-4) and information from Jenkens and Gilchrist and KPMG John Doe summons more than one year before issuing assessment notices. The court upheld the validity of requirements in Temp. Reg. § 301.6223(c)-1T that information be "filed" with the IRS at the Service Center where the taxpayer's returns are filed and that the identifying information be specific. The court interpreted § 6229(e)'s use of term "furnished" as sufficiently close to the filing requirement of the temporary regulations to indicate that the regulation was a valid exercise of administrative authority under *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984) and § 7805(a).

- The court also held that the taxpayer took an inconsistent position on returns reporting the partnership transactions because of the way the partnership netted contributions of long and short options which the taxpayer reported separately in claiming basis increases. As a result, the taxpayer was found to have failed to provide the statement required by § 6222(b) thereby extending the statute of limitations under § 6229(e)(2).

- The court also rejected the taxpayer's arguments that the IRS was estopped from assessing a deficiency because of (1) IRS delays in issuing Notice 2000-44, 2000-2 C.B. 255 (notifying taxpayers of the issues raised by the shelter transaction); (2) because of the long period before the IRS issued an FPAA to the taxpayer's partnership; or (3) because the IRS had withheld and destroyed evidence or placed witnesses beyond the reach of the taxpayer because of criminal investigations.

VIII. TAX SHELTERS

A. Tax Shelter Cases and Rulings

1. A Twenty First Securities tax shelter bites the dust. Samueli v. Commissioner, 132 T.C. 37 (2009). The taxpayer entered into a tax shelter transaction planned by Twenty First Securities (of *Compaq* fame), a simplified (☺) explanation of which is as follows. In October 2001, the taxpayer purchased fixed-income securities (Freddie Mac principal strips) from a broker (Refco) on a margin loan (Refco was entitled to hold the securities as collateral for the margin loan) and then "lent" the securities to Refco. The standard form agreement allowed the taxpayer to terminate the transaction and receive identical securities from Refco by giving notices on any business day, but an addendum overrode that provision and provided that the "loan" of the securities would terminate on January 15, 2003, or at the taxpayer's election on July 1 or December 2, 2002. The taxpayer purchased the securities for $1.64 billion, but immediately "lent" the securities to Refco and received cash "collateral" of $1.64 billion, which he used to repay the margin loan. The loan contracts provided that the taxpayer was entitled to receive all interest, dividends, and other distributions attributable to the securities, but that the taxpayer was obligated to pay Refco a variable rate fee for use of the $1.64 billion cash collateral. In December 2002, the taxpayer paid Refco $7.8 million of "interest" on the $1.64 billion cash collateral, which was re-lent to the taxpayer (secured by the securities, which had increased in value). The transaction terminated on January 15, 2003 and Refco was obligated to pay the taxpayer $1.69 billion to purchase the securities in lieu of transferring them to the taxpayer. The taxpayer was simultaneously obligated to pay Refco $1.68 billion, which reflected repayment of the $1.64 billion cash collateral, plus accrued but unpaid variable rate fees, but the amounts were offset and Refco paid the taxpayer $13.6 million. The taxpayer reported a $50 million long term capital gain and deducted $33 million of interest (cash collateral fees). Judge Kroupa held that the purported loan transaction did not satisfy the requirements of § 1058. To qualify as a loan of securities under § 1058, the loan agreement must (1) provide for the return to the lender of identical securities; (2) require payments to the lender equal to all interest, dividends, and other distributions on the securities during the period of the loan, and (3) not reduce the risk of loss or opportunity for gain of the transferor of the securities in the securities transferred. If any of these conditions is not satisfied, the purported loan will be treated as a realization event. Because the taxpayer could demand return of the securities only on three specified dates, and not at any time during the term of the loan, he could not sell the securities to realize a gain at any and all times that the possibility for a profitable sale arose. Thus, the taxpayer's opportunity for gain with respect to the transferred securities transferred was reduced. Judge Kroupa rejected the taxpayer's argument that because the taxpayer had not surrendered all opportunity to realize a gain with respect to the securities that the third condition prerequisite to qualifying for loan treatment under § 1058 had been satisfied. The statutory test for disqualification does not require complete elimination of the benefits of ownership, but merely a reduction. As a result, the "loan" of the securities in 2001 was treated as a sale on which no gain was realized (because the basis and amount realized were identical), and the "repayment" of the securities to the taxpayer in 2003 was treated as a repurchase followed by a resale to Refco on which a $13.5 million short term capital gain was realized. Furthermore, the taxpayer was not entitled to deduct the cash collateral fees paid as interest in connection with the purported securities lending arrangement because no debt existed. The cash transferred in 2001 represented the proceeds of the first sale and not collateral for a securities loan. Thus, no "cash collateral" was outstanding during the relevant years on which the claimed collateral fees could accrue.

a. On appeal, every argument in the taxpayer's kitchen sink goes down the drain. Samueli v. Commissioner, 658 F.3d 992 (9th Cir. 9/15/11). In an opinion by Judge Tashima, the Ninth Circuit affirmed the Tax Court. The first sentence was worded in an manner that left no suspense: "This case requires us to decide whether a purported securities loan with a fixed term of at least 250 days and possibly as long as 450 days, entered into not for the purpose of providing the borrower with access to the lent securities, but instead for the purpose of avoiding taxable income for the lender, qualifies for nonrecognition treatment as a securities loan pursuant to § 1058 ... ." The core reasoning of the Court of Appeals was the same as the Tax Court's.

> The plain language of § 1058(b)(3), with the gloss provided by elementary economic analysis, supports the Tax Court's conclusion on this point. Taxpayers relinquished all control over the Securities to Refco for all but two days in a term of approximately 450 days. During this period, Taxpayers could not have taken advantage of a short-lived spike in the market value of the Securities, because they had no right to call the Securities back from Refco and sell them at that increased price until several months later. Common sense compels the conclusion that this reduced the opportunity for gain that a normal owner of the Securities would have enjoyed.

- The court rejected the taxpayer's argument, which it labeled as "superficially appealing" that "their inability to secure the return of the Securities on demand did not affect their ability to recognize gain because the Securities were 'zero-coupon bonds whose value [did] not widely fluctuate with windfall profits at some momentary period,'" because "when one owns $1.6 billion of a particular security, even a small fluctuation in value can produce a significant opportunity, in absolute terms, for profit." Furthermore, "Refco's option to purchase the Securities at the LIBOR-based prices still affected Taxpayers' ability to realize the market price of the Securities on the dates when they had the option of getting them back from Refco."

- The court noted, however, that its conclusion that the transaction at issue reduced the taxpayers' opportunity for gain "does *not* necessarily imply a conclusion that a securities loan must be terminable upon demand to satisfy the requirements of § 1058(b)(3)," but declined to address the issue further, noting that additional guidance from the IRS and Treasury should deal with the issue.

- The court also rejected the taxpayer's argument that § 1058 is merely a safe harbor and even if the transaction did not qualify under § 1058, it nevertheless was a loan under general tax principles. Although the taxpayer's purchase of the securities funded by a margin loan had a non-tax business purpose, "[t]he sole motivation for adding the purported securities loan to the transaction was tax avoidance. ... Unlike a typical securities lending arrangement, this transaction was designed around minimizing Taxpayers' tax bill rather than around Refco's need to have the Securities available to deliver to its customers."

- The court also rejected the taxpayer's argument that § 1058 was irrelevant and the transaction was in substance the "liquidation" of a contract right to receive the securities from Refco, which would result in long term capital gain because the contract right was held for more than one year.

2. Low value, high substitute basis tax shelter falls on the absence of a partnership and a lack of economic substance. Rovakat, LLC. v. Commissioner, T.C. Memo. 2011-225 (9/20/11). This is a TEFRA partnership proceeding against a cookie-cutter tax shelter arrangement created by Lance O. Valdez who did business as a tax attorney and financial advisor. In this particular case, the taxpayer, Rovakat, was an LLC taxed as a partnership formed by International Capital Partners LP (ICP), a Cayman Islands partnership controlled by Valdez, and International Strategic Partners (ISP), a Delaware LLC, which was owned 99.6 percent by Mr. Hovnanian who acted as the tax matters partner for Rovakat, and the remaining interest was owned by ICP and another Valdez-controlled entity. In a series of transactions through partners in ICP, Rovakat acquired as a contribution from ICP 50,000 Swiss Francs with a fair market value of $34,185 in which ICP then Rovakat claimed a basis of $5.8 million. One month later, Mr. Hovnanian purchased 90 percent of ICP's interest in Rovakat for $30,776. The next day Rovakat sold the Francs for $30,776, and claimed a loss of $5,769,532. The court (Judge Laro) ruled for the IRS disallowing the losses after a trial that involved seven lay and three expert witnesses, 700 stipulated facts and over 600 exhibits, finding that—

- ICP, one of the Rovakat partners was not itself a partnership so that ICP's acquisition of the Francs provided it with a cost basis rather than a high transferred basis. Thus, in turn, Rovakat's basis in the Francs was only the cost basis of ICP. The court found that the ICP partners did not intend to join together to carry on a trade or business, but only to acquire tax basis in "what was otherwise a worthless shell entity."
- The transaction lacked economic substance under what the court described as the integrated two-part analysis of the economic substance doctrine, holding on consideration of multiple factors that the various transactions had no practical economic effect apart from tax savings, and that the taxpayer did not participate in the transaction for a valid non-tax business purpose.
- The court also held that Rovakat omitted $650,000 of gross income attributable to fees for consulting that were not offset by claimed deductions, and that this income was self-employment income subject to self-employment tax.
- To make victory complete, the court upheld § 6662 penalties indicating that the partnership's reliance on tax opinions from De Castro, West, Chodorow, Glickfield & Nass, Inc. and Sidley, Austin, Brown, and Wood LLP, was not reasonable reliance. As to the former, the court indicated that Mr. Hovnanian had no personal contact with the attorneys who wrote the opinion, and that the opinion contained material misstatements of fact. The Sidley Austin opinion was obtained by Valdez and ICP and made no reference to Hovnanian or Rovakat.

3. Another LILO tax shelter bites the dust. Can anyone really be surprised? Altria Group v. United States, 658 F.3d 276 (2d Cir. 9/27/11). Altria claimed $24,337,623 in depreciation, interest, and transaction cost deductions relating to nine leveraged LILO transactions with tax-indifferent entities. "In each transaction, Altria leased a strategic asset from a tax-indifferent entity; immediately leased back the asset for a shorter sublease term; and provided the tax-indifferent entity a multimillion dollar 'accommodation fee' for entering the transaction and a fully-funded purchase option to terminate Altria's residual interest at the end of the sublease term." The district court, in a jury trial, held that Altria was not entitled to the claimed tax deductions. "Applying the substance over form doctrine, the jury rejected Altria's contention that it retained a genuine ownership or leasehold interest in the assets and therefore was entitled to the tax deductions." Altria appealed on the grounds that the court's jury instructions were incorrect as a matter of law, and that the court erred by not entering judgment for it as a matter of law. The court of appeals affirmed, for all the usual reasons in LILO transactions.

4. *Culbertson* — Oh yeah!, but *Canal* — No thanks! Southgate Master Fund LLC v. United States, 659 F.3d 466 (5th Cir. 9/30/11). The Fifth Circuit affirmed a District Court decision upholding the disallowance of artificial loss deductions generated by a complex multi-party Chinese non-performing loan (NPL) investment transaction. The taxpayer invested approximately $19.4 million in a transaction, structured through the purchase of a partnership interest in a partnership that held the NPLs, which purported to produce tax losses of approximately $210 million. [Note: Under current § 704(c)(1)(B), the transaction would have failed on a technical analysis.] To pass the losses through without running afoul of the § 704(d) limitation, the taxpayer purported to have contributed securities with a basis of over $180 million to the partnership. Although the acquisition of the NPLs had economic substance under the Fifth

Circuit precedent in *Klamath Strategic Inv. Fund v. United States*, 568 F.3d 537 (5th Cir. 2009), Southgate was a "sham" partnership under a *Culberson* analysis (*Commissioner v. Culbertson*, 337 U.S. 733 (1949)). The parties did not join together with a business purpose to share profits. Applying a "substance over form" analysis, the court concluded that the acquisition of the portfolio of NPLs was a direct acquisition by the purported partners. Nevertheless, the Court of Appeals affirmed the District Court's holding that no § 6662 accuracy related penalties should be imposed. There was no error in the District Court's finding that the taxpayer reasonably relied on "more likely than not" opinions from his tax advisors, who had structured the deal.

5. **Given the government's winning percentage in tax shelter cases, is continued litigation of tax shelter cases really just self-help welfare for tax controversy attorneys?** WFC Holdings Corp. v. United States, 108 A.F.T.R.2d 2011-6531 (D. Minn. 9/30/11). A tax shelter so complicated that we cannot understand from the opinion how it purported to work bit the dust because it was "devoid of economic substance." We think it was based on a variation of the kind of structure involved in *Coltec Industries v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied,* 549 U.S. 1261 (2007).

6. **Yet another investor in a KPMG OPIS tax shelter gets devoured by the economic substance doctrine.** Blum v. Commissioner, T.C. Memo. 2012-16 (1/17/12).The taxpayer's bogus $45 million loss claimed from a KPMG OPIS tax shelter was disallowed. The taxpayers did not contest that their loss was "fictional." Section 6662 accuracy-related penalties for gross valuation misstatements and negligence were upheld.

7. **Had this opinion been issued on October 25th, taxpayer might have had a chance. However, the opinion was issued on March 14th, so success was not in the cards**. Crispin v. Commissioner, T.C. Memo. 2012-70 (3/14/12), on appeal to the Third Circuit. Taxpayer, an experienced CPA, entered into a CARDS transaction in 2001 to shield about $7 million of shared fees (ordinary) income from his wholly owned S corporation that engaged in a business related to a pool of collateralized mortgage obligations. The promoter was a longtime friend who did not charge the taxpayer any fee to participate in the CARDS transaction. The Tax Court (Judge Kroupa) held that the transaction lacked economic substance because it lacked business purpose and profit expectation, stating, "[w]e have consistently held that CARDS transactions lack economic substance," and noting that an appeal in this case lies in the Third Circuit, which decided *ACM P'ship v. Commissioner*, 157 F.3d 231 (3d Cir. 1998).

- Judge Kroupa also upheld the 40 percent gross valuation misstatement accuracy-related penalty. The tax opinion the taxpayer received from his advisors relied on "false representations [the taxpayer] made," including that he had a business purpose for entering into the CARDS transaction and that he anticipated earning a profit, absent tax benefits, from the CARDS transaction, which were "material to the conclusions reached in the tax opinion." Furthermore, the taxpayer had not actually relied on the opinion.

8. **Just another generic tax shelter that lacks economic substance — Taxpayer, "you lose."** Reddam v. Commissioner, T.C. Memo. 2012-106 (4/11/12). The taxpayer invested in an OPIS tax shelter peddled by KPMG. The Tax Court (Judge Goeke) found that the "'pretax profit' potential of the transaction was so remote as to render disingenuous any suggestion that the transaction was economically viable."

> [The taxpayer] knew little to nothing about the details of the OPIS transaction. The extent of his knowledge was limited to an understanding that the OPIS transaction was a "formula or a recipe" that would provide him with a substantial capital loss. Despite the fact that petitioner and his closest advisers were ignorant as to the function and design of the investment, petitioner never investigated the transaction further, relying instead on the opinion letters provided by or on behalf of KPMG. Petitioner's lack of due diligence in researching the OPIS transaction indicates that he knew he was purchasing a tax loss rather than entering into a legitimate investment.

Back to Table of Contents

- Accordingly, the losses claimed by the taxpayer were denied on the grounds that the transaction lacked economic substance. Amazingly, the opinion makes no reference to accuracy related penalties — did the IRS forget to assess penalties?

9. You better hope that your H-P computer works better than H-P's tax planning strategies. Hewlett-Packard Co. v. Commissioner, T.C. Memo. 2012-135 (5/14/12). In a complicated transaction designed by AIG-Financial Products to generate foreign tax credits, Hewlett-Packard purchased a preferred stock interest in a foreign entity called Foppingadreef (FOP) that was to engage in a U.S.-dollar linked Netherlands guilder stepped coupon contingent note transaction which took advantage of asymmetric treatment of contingent interest in the U.S. and the Netherlands. The common stock of FOP was held by the Dutch bank, ABN, which also provided capital to FOP through transactions structured as a loan to an AIG subsidiary which in turn transferred the Dutch guilder proceeds to FOP along with an obligation on the part of FOP to pay contingent interest back to ABN. Hewlett Packard treated FOP as a controlled foreign corporation through its ownership of the preferred stock and warrants to acquire additional stock and claimed foreign tax credits for Dutch taxes. The transaction was structured to terminate in 2003 through the exercise of put options to transfer Hewlett-Packard's stock interest back to ABN for a price that resulted in a loss to Hewlett-Packard. The Tax Court (Judge Goeke), applying the multiple factors used to distinguish debt from equity, found that the structure of the transaction resulted in a fixed repayment of Hewlett-Packard's investment on a fixed date and treated the investment as a loan rather than an equity interest in FOP, thereby disallowing claimed foreign tax credits. The court also disallowed Hewlett-Packard's claimed § 165 loss on the difference between its initial investment and the price it received on the termination date. The court agreed with the IRS's assertion that Hewlett-Packard's claimed $15.5 million loss on termination of the transaction was in effect a fee paid to AIG in order to participate in a tax shelter. The court held that fees spent for the generation of artificial tax losses are not deductible as payments incurred in a transaction that lacked economic substance citing *Enrici v. Commissioner*, 813 F.2d 293, 296 (9th Cir. 1987), and *New Phoenix Sunrise Corp. v. Commissioner*, 132 T.C. 161, 186 (2009), aff'd. 408 Fed. Appx. 908 (6th Cir. 2010). The court also noted that Hewlett-Packard failed to meet its burden of proof regarding the proper timing of the deduction.

10. "A [contingent liability section 351] transaction that would let [the taxpayer] deduct an approximately $38 million tax loss on the sale of $11,000 in securities which had just recently been purchased for the same amount ... would clearly appear to be too good to be true." Gerdau MacSteel, Inc v. Commissioner, 139 T.C. No. 5 (8/30/12). To shelter capital gains of over $41,000,000 recognized on the sale of two subsidiary corporations in 1997, the taxpayer (Quanex), which was the parent in a consolidated group, entered into a tax shelter transaction devised and recommended by Deloitte &Touche that was intended to create an artificial short-term capital loss of approximately $38,000,000 to offset the capital gains. The loss was to be created in a series of transactions involving Quanex's liabilities under for its medical plan benefits (MPBs). In simplified form, the transaction involved the following steps using two of Quanex's inactive subsidiaries (QS) and (QHMC): (1) Quanex caused QHMC to be recapitalized to have multiple classes of stock, including Class B and Class C voting preferred stock, (a) each with "an assumed $100 issue price," (b) cumulative dividends of 9.5%, payable quarterly, providing Quanex or QHMC with rights to call the preferred stock after five years and providing the Class C shareholders with rights to put the preferred stock after seven years, and (c) providing for a liquidation value for the Class C stock in amount equal to the greater of $125 or an amount equal to the lesser of a percent of any cumulative cost savings in MPBs or of QHMC's book net equity.; (2) Quanex transferred $38,000,000 to QS, which assumed Quanex's contingent liability to pay MPBs under Quanex's benefits plan which were treated as being in the amount of $37,989,000; (3) QS transferred $38,000,000 to QHMC, which in turn assumed the liability to pay Quanex's MPBs, in exchange for newly issued Class C stock, and (4) QS sold its Class C preferred stock to a former employee of a Q subsidiary for $11,000. The taxpayer took the position that the transfers of $38 million and the assumptions of liability were § 351 nonrecognition transactions and that pursuant to § 358(a)(2) and Rev. Rul. 95-74, 1995-2 C.B.

36, QS's basis in the QHMC stock was $38,000,000 unreduced by the $37,989,000 of MPBs that were not deductible until paid. The taxpayer claimed a $37,989,000 loss recognized on the sale of the Class C stock that was used to offset the capital gains on the sales of the other subsidiaries. The Tax Court (Judge Marvel) found as facts that the transactions were structured in such a way that it was highly likely when the Class C stock was issued that the Class C stock would be redeemed within the five- and seven-year periods and that the redemption payment would be $125 per share. Judge Marvel further found that after the transactions, Quanex continued to process claims for MPBs, and its handling of the claims transferred to QHMC was the same as the handling of claims with respect to individuals whose MPBs were not transferred to QHMC. QHMC's reimbursements to Quanex for claims were made through intercompany entries recorded on Quanex's books as a receivable due from QHMC and on QHMC's books as a payable. QHMC lent the $38 million to an affiliated corporation, and QHMC eventually reimbursed Quanex for the MPBs when QHMC received payments on the loan. Based on the fact finding, Judge Marvel disallowed the loss deduction on two grounds. First, she held that because the Class C stock "'does not participate in corporate growth to any significant extent' within the meaning of I.R.C. sec. 351(g)(3)(A)" it was nonqualifed preferred stock as defined in § 351(g). The taxpayer and IRS had stipulated that if the Class C stock was found to be nonqualifed preferred stock the claimed loss was not allowable. (The opinion does not explain the reason that the claimed loss was not allowable if the Class C stock was nonqualifed preferred stock.) The loss also was also disallowed under the economic substance doctrine, as was a § 162 deduction for $352,251 of fees incurred to effect the transactions. Judge Marvel found no business reason for assumption by QHMC of the MPB liabilities, the sale of the Class C stock, or any other aspect of the transactions; the transactions were all entirely tax motivated, for the purpose of generating an artificial loss. The court also upheld a § 6662(a) 20 percent accuracy penalty (and alternatively a substantial understatement penalty).

> [A] transaction that would let petitioners deduct an approximately $38 million tax loss on the sale of $11,000 in securities which had just recently been purchased for the same amount, and that this result, to a savvy, experienced businessman ... would clearly appear to be too good to be true.

- Thus, the reasonable cause exception of § 6664(c) was not available But applying the *Golsen* rule, followed the Fifth Circuit's precedents in *Heasly v. Commissioner*, 902 F.2d 380 (5th Cir. 1990), *rev'g* T.C. Memo. 1988-408, and *Todd v. Commissioner*, 862 F.2d 540 (5th Cir. 1988), *aff'g* 89 T.C. 912 (1987), in declining to sustain a 40 percent penalty asserted by the IRS, because the grounds underlying the court's disallowance of the capital loss deduction were not directly related to the taxpayer's valuation of the Class C stock or to the reporting of the proper basis therein.

11. Double deductions are a "No No!" Thrifty Oil Co. v. Commissioner, 139 T.C. No. 6 (8/30/12). Thrifty was the common parent of a consolidated group for the relevant years (fiscal years ending 9/30/96 - 9/30/02), but only the years ending in 2000 through 2002 were at issue. During the fiscal year ending in 1996, Thrifty had generated and claimed a capital loss by causing a subsidiary (GW) to transfer a $29,100,000 note from another subsidiary (B) to yet another preexisting subsidiary (EM), which had assumed contingent environmental liabilities in transaction in exchange for 90 shares EM stock. The taxpayer took the position that the transfer of the $29,100,000 note and the assumption of the $29,070,000 of contingent environmental remediation liabilities was a § 351 nonrecognition transaction and that pursuant to § 358(a)(2) and Rev. Rul. 95-74, 1995-2 C.B. 36, GW's basis in the EM stock was the $29,100,000 face value of the B note, without reducing the stock basis by the $29,070,000 of contingent environmental remediation liabilities EM assumed, which were not deductible until paid. Three days later (9/30/96), GW sold its EM stock for $25,200 and claimed a capital loss of $29,074,800. The taxpayer deducted a total of $18,347,205 of the capital loss on its 1996 through 1999 tax returns, years which were beyond the statute of limitations at the time the dispute in the case arose. The taxpayer claimed deductions for the remaining $10,727,595 of the capital loss on its 2000 and income tax returns, and those carryforwards were disallowed by the IRS. The sale of the 90 shares of EM stock had not broken EM's affiliation with the consolidated group, and in the years 2000 through 2002, the Thrifty group claimed § 162 deductions for $11,109,962 of environmental remediation expenses that were accruable in those years. The IRS disallowed the deductions. After stipulations — the taxpayer conceded the capital loss issue and the IRS conceded the deduction for environmental remediation expenses that had not previously been deducted in closed years as capital losses, as well as any penalties — the only issue for the court was the deductibility of the $11,109,962 of environmental remediation expenses in 2000 through 2002. The Tax Court (Judge Wherry) applied *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62 (1934), and its progeny to disallow the deductions as "double deductions" that had been previously claimed as capital losses in the closed years 1996 through 1999. The court reasoned that under its applicable precedents and the applicable precedents in the Ninth Circuit, to which the case was appealable, "[i]f the deductions represent the same economic loss to [the taxpayer] and [the taxpayer] cannot point to a specific provision demonstrating Congress' [*sic*] intent to allow the double deductions, then the claimed environmental remediation expense deductions must be disallowed." Factually, there was a "double deduction" because "the capital loss arose not as a result of how basis was calculated but as a result of the contingent environmental remediation liabilities being taken into account in calculating the amount realized (or fair market value) but not in calculating basis." Furthermore, § 162, a general deduction provision, does not reflect a "clear declaration of intent" to allow a double deduction. Moreover, under Ninth Circuit precedent in *Stewart v. United States*, 739 F.2d 411 (9th Cir. 1984), as well as cases from other courts, it was immaterial to the application of *Charles Ilfeld Co.* whether the earlier deduction was proper or erroneous but not timely challenged by the IRS.

B. Identified "tax avoidance transactions"

C. Disclosure and Settlement

D. Tax Shelter Penalties, etc.

1. Tax professionals compensated at hourly rates were "independent advisers," but § 6662 penalties were nevertheless imposed because the Son of BOSS transaction was "too good to be true." Candyce Martin 1999 Irrevocable Trust v. United States, 822 F. Supp. 2d 898 (N.D. Cal. 10/8/11). Trusts for the San Francisco Chronicle heirs and the heirs themselves entered into digital option Son-of-Boss transactions to shield more than $300 million of capital gain from taxation arising from the sale of their stock in Chronicle Publishing Company in 2000. Judge Hamilton held that the transactions failed for federal income tax purposes because (1) the obligations on the short options constituted liabilities for purposes of § 752; (2) the transactions lacked economic substance; and (3) the transactions were not entered into for profit so losses were nondeductible under § 165.

- The trustee of the trusts [Peter Folger] and the leading Martin family member [Francis Martin] engaged San Francisco tax lawyer Richard Sideman – a Harvard Law School graduate, with a Masters in Tax from NYU, who had previously advised the family on gift tax and trust reformation issues – to advise the trusts and heirs as to the tax and non-tax consequences of their Chronicle Publishing stock sale. Sideman did a great deal of investigation by getting advice from large accounting firms, investment banks, economists, and R.J. Ruble, which resulted in proposed transactions and proposed opinion letters undergoing numerous changes. Finally, the transactions proposed by JP Morgan and implemented by PWC, with R.J. Ruble opinion letters were decided upon; Sideman "greenlight[ed]," i.e., approved, the transactions. In upholding § 6662 penalties and denying taxpayers' "reasonable cause and good faith defense," Judge Hamilton stated:

> [M]ere reliance on the advice of a professional tax advisor "does not necessarily demonstrate reasonable cause and good faith." Id. A taxpayer's claim of reliance upon professional advice as support for this defense is to be evaluated under an objective standard. …
>
> While the record is clear that Mr. Folger and the Martin family relied heavily on Mr. Sideman, the record is not clear as to the extent that they relied directly on the advice of Dr. Rubinstein and Mr. Ruble, if at all. It was Mr.

Back to Table of Contents

> Sideman who appears to have relied on the advice of Dr. Rubinstein and Mr. Ruble in advising Mr. Folger and the Martin family.
>
> … [A]ny reliance on Dr. Rubinstein's advice would not be reasonable because his conclusions were not based on all pertinent facts and circumstances as required for reasonable cause.
>
> … Mr. Sideman testified that he saw his role as that of overseeing the transaction "in a broad way [and] hiring or engaging at my recommendation the most qualified people that I knew who could provide the actual expertise about the transaction and about its financial implications." … Mr. Sideman characterized himself as a tax controversy lawyer, unfamiliar with economic judgments involving financial matters to advise the Martin family directly on the issue whether the tax proposal by Arthur Andersen, and the subsequent proposal by PWC, would have an economic reality or economic benefit. Mr. Sideman testified that he relied on the advice of PWC, Dr. Rubinstein and Mr. Ruble to examine the business purpose of the proposed transaction. …
>
> While the evidence at trial establishes that Mr. Folger and the Martin family relied on Mr. Sideman's advice, the trial evidence lacks clarity as to exactly what advice Mr. Sideman gave them, other than approving or "greenlighting" the transaction based on the advice he received from the other professionals. The weaknesses noted above in the Ruble and Rubinstein opinions, as well as other aspects of the transaction, should have put at least Mr. Sideman, if not the taxpayers, on notice that the transaction was a questionable tax avoidance scheme lacking economic substance. However, the question before the court is not whether Mr. Sideman's reliance on professional advice was reasonable, but whether Mr. Folger and the Martin family's reliance on Mr. Sideman's and the other professionals' advice was reasonable. As previously noted, it is not clear to what extent the taxpayers themselves relied on any advice other than Mr. Sideman's. Nor was it established that Mr. Sideman ever specifically advised them that the transaction was bona fide or legal. All the evidence clearly establishes is that Mr. Sideman approved the transaction.

- Judge Hamilton rejected government contentions that the taxpayers could not rely on PWC and Sideman because they had an inherent conflict of interest, stating that advisers compensated at an hourly rate were not conflicted.
- However, the court found that taxpayers did not rely reasonably on Sideman's advice, concluding:

> The government has not provided a clear argument or any authority for whether Mr. Sideman's unreasonable reliance on the professionals he hired should be imputed to the taxpayers. This was a highly sophisticated transaction, one for which a taxpayer would reasonably be expected to hire a tax lawyer. The court is not prepared to find that having retained a tax lawyer who "greenlights" a complicated transaction as having a business purpose, a taxpayer necessarily acts unreasonably by relying on that advice. See United States v. Boyle, 469 U.S. 241, 250-51, 105 S. Ct. 687, 83 L. Ed. 2d 622 (1985) (when an accountant or attorney advises a taxpayer on a matter of tax law, it is reasonable for the taxpayer to rely on that advice, "even when such advice turned out to have been mistaken"). Even assuming, however, that the taxpayers acted reasonably in relying on their tax lawyer's advice to proceed with the transaction, to be entitled to the reasonable cause and good faith defense, the taxpayers must also prove that they acted in good faith. Good faith is not synonymous with objective reasonableness. Even if the concept of business purpose was too complicated for the taxpayers to assess and apprehend, the court finds that Mr. Folger and the Martin family have not demonstrated good faith under the circumstances and in light of the underlying purposes of entering into the transaction.

First, Mr. Folger and the Martin family should have known that the transaction resulting in a $315.7 million tax basis for a $0.9 million offsetting options transaction was "too good to be true." *Stobie Creek*, 608 F.3d at 1383. Furthermore, they knew that the purpose of the transaction was to boost the basis to generate a large capital loss to offset the capital gains from the CPC sale. Finally, they proceeded with the transaction even after the issuance of Notice 2000-44, entitled "Tax Avoidance Using Artificially High Basis," which alerted them that the basis created by the options transaction would likely be disallowed. Although they were advised by Mr. Sideman that the transaction had a legitimate business purpose, Mr. Folger and the Martin family entered into this transaction with the knowledge that it would generate an artificially high capital loss. Given the level of education and business experience shared by Mr. Folger and the Martin family, they should have known that the absence of a tax liability on a sizeable capital gain did not reflect the economic reality of the transaction. The underpayment of tax was not, therefore, the result of "an honest misunderstanding of fact or law." Treas. Reg. § 1.6664-4(b)(1). Because Mr. Folger, with the consent of the Martin family, did not act in good faith, the court finds that the accuracy-related penalty was appropriately applied here.

2. **Conceding that a 2001 transaction lacked economic substance avoided the § 6662(h) 40-percent gross valuation misstatement penalty, but this particular ploy won't work as well for years to which the § 6662(b)(6) strict liability penalty applies.** Bergman v. Commissioner, 137 T.C. 136 (10/11/11). The taxpayers, the husband taxpayer being a partner in KPMG, participated in two SOS (Short Option Strategy) transactions promoted by KPMG that was the same as or substantially similar to a tax avoidance transaction described in Notice 2000-44, 2000-2 C.B. 255. The IRS served KPMG with a summons concerning transactions described in Notice 2000-44, seeking among other things, a list of clients that had engaged in such transactions. KPMG provided a list that included the taxpayer's 2000 transaction but not the 2001 transaction. After filing original returns claiming the deductions from the SOS transactions, subsequent to the IRS issuing the summons to KPMG, the taxpayers filed amended returns that eliminated the losses. The IRS argued that the summons terminated the period for the taxpayers to file a qualified amended return under Reg. § 1.6664-2(c)(3), and the taxpayers conceded they were liable for a 20-percent accuracy-related penalty under § 6662(a) if they failed to file a qualified amended return, but that their amended returns were a qualified amended returns. In addition, the IRS also asserted that the taxpayers were liable for a 40-percent gross valuation misstatement under § 6662(h) if the amended returns were not qualified amended returns. This required the court (Judge Kroupa) to decide whether the IRS must impose a promoter penalty under § 6700 (relating to abusive tax shelters) to terminate the time to file a qualified amended return under Reg. § 1.6664-2(c)(3)(ii). The taxpayers argued that the IRS failed to establish that KPMG was liable for a promoter penalty under § 6700 and therefore the time to file a qualified amended return never terminated. With regard to the first issue, Judge Kroupa held that the period to file a qualified amended return terminated before the taxpayers filed the amended return. The taxpayers "could reasonably conclude that [the IRS] would discover their 2000 transaction once KPMG was served the Notice 2000-44 summons. Accordingly, disclosure after the Notice 2000-44 summons was served on KPMG would not have been voluntary." The amended return petitioners filed was not a QAR since it was filed after respondent issued KPMG the Notice 2000-44 summons. As a result, for penalty purposes, the additional tax stated on the amended return was not includable in the amount of tax shown on the original return, and the taxpayers had an underpayment of tax for 2001 equal to the additional tax reported on the amended return. But with regard to the second issue, she held that the taxpayers' underpayment was not attributable to a gross valuation misstatement and they thus were not liable for the gross valuation penalty. *McCrary v. Commissioner*, 92 T.C. 827 (1989), held that where the IRS asserts a ground unrelated to value or basis of property for totally disallowing a deduction or credit and a taxpayer concedes the deduction or credit on that ground,

any underpayment resulting from the concession is not attributable to a gross valuation misstatement; that holding was extended in *Rogers v. Commissioner*, T.C. Memo. 1990-619, to situations where the taxpayer does not state the specific ground for the concession as long as the IRS has asserted some ground other than value or basis for totally disallowing the relevant deduction or credit. In this case the taxpayers conceded that the transactions lacked economic substance, and thus had conceded "'on grounds other than regarding the value or basis of the property' that they were not entitled to deduct any portion of the losses at issue."

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

1. Your client put it off for three years, so why not put it off until year-end 2012: Organizations which lost their tax-exempt status may seek reinstatement until 12/31/12. IR-2011-63 (6/8/11). This information release provides guidance to help reinstate currently-existing organizations among the 275,000 which lost their tax-exempt status for failure to file required annual reports for three consecutive years. Notice 2011-43, 2011-25 I.R.B. 882; Notice 2011-44, 2011-25 I.R.B. 883; and Rev. Proc. 2011-36, 2011-25 I.R.B. 915, provide full details.

2. Even the Tax Court is anti-union. National Education Association v. Commissioner, 137 T.C. 123 (9/28/11). National Education Association (NEA) is a tax-exempt labor organization described in § 501(c)(5). It published two magazines at an expense of about $7 million that it distributed to dues-paying members and to a few non-member paying subscribers. NEA's literature stated that members received the magazines as a benefit of membership and stated an amount of dues that paid for the magazines. Members who declined the magazines did not pay a smaller amount of dues. NEA made most but not all of the content of the magazines available for free over the Internet to the general public. NEA published paid advertising in the magazines from which it earned annual net income of approximately $1 million. NEA reported negligible circulation income, resulting in a substantial claimed loss on its circulation activity; NEA used that loss to fully offset its taxable advertising profit. Thus, NEA reported that it owed no unrelated business income tax (UBIT). The IRS allocated a portion of NEA's membership dues to circulation income, which resulted in NEA having circulation income substantially in excess of the advertising income, resulting in the advertising income being UBIT. Reg. § 1.512(a)-1(f)(3)(iii) provides that "[w]here the right to receive an exempt organization periodical is associated with membership or similar status in such organization for which dues, fees or other charges are received (hereinafter referred to as 'membership receipts'), circulation income includes the portion of such membership receipts allocable to the periodical (hereinafter referred to as 'allocable membership receipts')." The NEA argued that its members did not have 'the right to receive' the magazines because it was under no obligation to continue publishing and because its members as well as the general public could access the magazines for free on the Internet. On these grounds, the NEA argued that it thus had virtually no circulation income, but had substantial excess readership costs that it could deduct from its advertising income, reducing that income to zero. The IRS argued that NEA members had the right to receive the magazines because a portion of the NEA's members' dues was paid for magazines. As a result, the NEA had substantial circulation income that more than covered the cost of producing the magazines; thus it had no excess readership costs, and accordingly had unrelated business taxable income from its paid advertising. The Tax Court (Judge Gustafson) upheld the deficiency, finding that the NEA members, in fact, had a right to receive the publications. Under its bylaws it could not "halt publication of the magazines at its whim," its contracts with advertisers limited its right to halt publication, as did relevant postal regulations. Furthermore, the enrollment forms used by State affiliates, through which all NEA members joined, separately listed the portion of the dues allocable to the publication subscriptions and promised delivery of the publications. Finally, the court concluded that the alternative free availability of a publication to members did not nullify their right to receive the publication resulting from payment of dues.

- As a preliminary matter the court rejected the IRS's argument that "the principle that an agency's interpretation of its own regulation is controlling unless it is 'plainly erroneous or inconsistent with the regulation'" applied in this case. The court concluded that "[d]eference here to the agency's interpretation is difficult, second, because the IRS is unable to show that the agency has in fact stated a position on the interpretation of 'right to receive.'"

3. The exclusivity of a gated parking lot for the neighborhood beach club has a tax price. Ocean Pines Association v. Commissioner, 135 T.C. 276 (8/30/10). The taxpayer was a homeowners association that was tax-exempt under § 501(c)(4) as a not-for-profit organized to promote community welfare. In addition to enforcing zoning and providing roads and recreational facilities within Ocean Pines, funded by members' dues (but which were open to both members and nonmembers), it operated a beach club and parking lots eight miles from the area (Ocean Pines) in which its members lived. The primary beach club facilities (e.g., pool, locker room, etc.) and parking lots were accessible only to the association's members and their guests, but the snack bar, restaurant, and beach itself were open to the public. The taxpayer charged its members a separate fee for parking permits, and maintained a parking permit system and guards. It also leased the parking lots to third-party businesses at night and in the off season. The taxpayer did not report any of the income as subject to the unrelated business income tax (UBIT). The IRS issued a deficiency notice determining that the net income from the parking lots and beach club facilities was subject to UBIT, because their operation was not substantially related to the promotion of community welfare. The Tax Court (Judge Morrison) upheld the deficiency. The court concluded that the operation of the beach club and the parking lots did not promote community welfare because they were not accessible to nonmembers, i.e., the general public. Therefore, unless an exception applied, the income was subject to UBIT. Finally, the court held that the § 512(b)(3)(A)(i) exception for rents from real property did not apply, because Reg. § 1.512(b)-1(c)(5) provides that income from the operation of a parking lot is not rent from real property.

a. Affirmed — Parking lots and a beach club that benefit only those who own property in a private community and their guests that provide "a private refuge for those who would live apart," do not promote social welfare. Ocean Pines Association, Inc. v. Commissioner, 672 F.3d 284 (4th Cir. 3/2/12). The Fourth Circuit (in an opinion by Judge Motz) affirmed the Tax Court's decision in favor of the government. The Court of Appeals holding made three key points. First, "facilities that do not permit access to the general public – like the parking lots and beach club – simply do not promote 'social welfare.'" Second, the court rejected the taxpayer's argument that "'social welfare' must be interpreted through the lens of the Association's charter, *which aims to promote the community welfare of the Association's members rather than that of the general public*," holding that "[n]otwithstanding the Association's charter, the purpose that constitutes the basis of the Association's exemption under § 501(c)(4) is its promotion of "social welfare" *as defined by the statute and regulations*." (emphasis added) Third, the court rejected the taxpayer's argument that "Congress's purpose in enacting the unrelated business income tax was to avoid unfair competition with private enterprise, and that a rule requiring a business operated by a 501(c)(4) organization to be open to the general public in order to avoid taxation would frustrate that purpose." Rather, the court held that "[t]he plain language of the statute and regulations speak with . . . clarity ... . [T]he only question . . . is whether the parking lots and beach club are 'substantially related' to the Association's tax-exempt purpose," which they were not. Thus, the income was subject to UBIT.

4. Proposed regulations on program-related investments. REG-144267-11, Examples of Program-Related Investments, 77 F.R. 23429 (4/19/12). The proposed regulations add nine examples depicting a wider range of investments that qualify as program-related investments. The new examples demonstrate that a program-related investment may accomplish a variety of charitable purposes, such as advancing science, combating environmental deterioration, and promoting the arts. Several examples also show that an investment funding activities in one or more foreign countries, including investments that alleviate the impact of a natural disaster or that fund educational programs for poor individuals, may further the accomplishment of charitable purposes and qualify as a program-related investment.

Back to Table of Contents

B. Charitable Giving

1. Conditionally revocable conservation easements are no-good. Carpenter v. Commissioner, T.C. Memo. 2012-1 (1/3/12). Conservation easements that could be extinguished by the mutual consent of the donor taxpayer and the donee organization failed as a matter of law to comply with the enforceability in perpetuity requirements under Reg. § 1.170A-14(g). The easements were not protected in perpetuity and thus were not qualified conservation contributions under § 170(h)(1).

2. Both their house and their claimed charitable contribution deduction went up in smoke. Rolfs v. Commissioner, 135 T.C. 471 (11/4/10). The taxpayers donated a home, but not the underlying land, to the local volunteer fire department to be burned down in a training exercise. The fire department could not use the house for any purpose other than destruction by fire in training exercises. The taxpayers claimed a charitable contribution deduction of $76,000 based on a "before and after" valuation, comparing the value of the parcel with the building intact and the value of the parcel after demolition of the building; they complied with all record keeping and substantiation requirements. The Tax Court (Judge Gale) upheld the IRS's denial of the deduction. First, based on expert testimony, he found that the taxpayers received a quid-pro-quo in the amount of $10,000, which was the value of the demolition services provided to them by the donee fire department. Second, he found that the building, with ownership severed from the land and burdened by the condition that it be removed, i.e., in this case demolished, had no value. The lack of value was established by the expert testimony of home movers, who testified that considering the costs of removal to another site, the modest nature of the home, and the value of nearby land, no one would purchase the home for more than a nominal amount, between $100 and $1,000, sufficient to render the contract enforceable. Applying the principles of *Hernandez v. Commissioner*, 490 U.S. 680 (1989), and *United States v. American Bar Foundation*, 477 U.S. 105 (1986), Judge Gale held that because the consideration received by the taxpayers exceeded the value of the transferred property, there was no charitable contribution. He rejected application of the "before and after" valuation method, because that method did not take into account the restrictions that would have affected the marketability of the structure severed from the land.

a. While the Tax Court opinion is very fact specific, the Court of Appeals affirmance looks to establish a broader principle. Rolfs v. Commissioner, 668 F.3d 888 (7th Cir. 2/8/12). In an opinion by Judge Hamilton, the Seventh Circuit affirmed the Tax Court's decision. The Seventh Circuit concluded that "proper consideration of the economic effect of the condition that the house be destroyed reduces the fair market value of the gift so much that no net value is ever likely to be available for a deduction, and certainly not here." The appellate court reasoned that "the fair market valuation of donated property must take into account conditions on the donation that affect the market value of the donated property," and that the Tax Court properly rejected the before-and-after method for valuing a donation of property conditioned on the destruction of the property. The valuation must take into account any reduction in fair market value that results from the condition. Moving and salvage, under which the house had no actual value, were analogous situations reasonably approximated the actual facts. The before-and-after valuation method proffered by the taxpayer was not appropriate, because the facts were not analogous to conservation easements, where that method typically is used; in this case the donation destroyed the residential value rather than transferring it.

b. Another burning house charitable contribution deduction goes up in smoke. Patel v. Commissioner, 138 T.C. No. 23 (6/27/12). In 2006 the taxpayers purchased residential property with the intention to demolish the house and construct a new one on the site. Shortly after purchasing the property, the obtained a demolition permit and executed documents granting the local fire department the right to conduct training exercises on the property and to destroy the house by burning during the exercises. Soon thereafter live fire training exercises were conducted and the house was destroyed. The taxpayers claimed a noncash charitable contribution of $339,504 for the donation of the house to the fire department, but the IRS disallowed the deduction on the ground that the donation was a contribution of a partial interest in property, a deduction for which is denied by § 170(f)(3). In a reviewed opinion by Judge Dawson, the Tax Court granted summary judgment for the IRS and upheld the denial of the deduction. The court reasoned that under the controlling (Virginia) state law, the taxpayers had merely granted the fire department a license to conduct training exercises on the property and to destroy the building, which did not convey any interest in the building to the fire department. In doing so, they conveyed only a partial interest in the land. Section 170(f)(3) thus denies any charitable contribution deduction for the donation of the use of the property regardless of the value of that use. However, the taxpayers acted with reasonable cause and in good faith and were not liable for any accuracy-related penalty under §§ 6662(a) or (h), because at the time they filed their return, *Scharf v. Commissioner*, T.C. Memo. 1973-265, which held that a charitable contribution deduction was available for the donation of a building to a volunteer fire department for demolition in firefighter training exercises was the only relevant case law.

- An appendix explained that a license does not convey an interest in the property under the common law in any state or the District of Columbia.
- Judges Colvin, Cohen, Vasquez, Thornton, Marvel, Gustafson, and Morrison joined in the opinion of the court. Judge Paris concurred in the result only.
- Judge Gale, in an opinion joined by Judges Halpern, Foley, Goeke, Wherry, Kroupa, and Holmes, dissented. The dissent reasoned that the taxpayers had not merely granted a license, but "by virtue of the fire department's severance and destruction of the house, petitioners in substance ceded all substantial property interests they held in the structure to the department." Citing *Rolfs v. Commissioner*, 668 F.3d at 888 (7th Cir. 2012), *aff'g* 135 T.C. 471 (2010), in which Judge Gale wrote the Tax Court opinion, the dissent noted that to be entitled to a charitable contribution deduction, the taxpayers "must show that the value of the house, taking into account the conditions on its donation, exceeded the value of the benefit they received from the fire department in the form of demolition services." Thus the dissenters would have denied the motion for summary judgment and proceeded to trial on that fact question.
- Judge Berrigan dissented but did not join in Judge Gale's dissent or write separately.

3. Mining is not the highest and best use for land that no one actually wants to mine. Esgar Corp. v. Commissioner, T.C. Memo. 2012-35 (2/6/12). The taxpayers granted conservation easements in certain land that was zoned irrigated, agricultural, and which had historically been used as irrigated and nonirrigated farmland. The land was not permitted for any mining, but absent the donations it was likely that the necessary permits to mine (gravel) could have been obtained. The terms of the conservation easements provided the donee organization perpetual rights to preserve the natural and open space conditions and protect the wildlife, ecological, and environmental values and water quality characteristics of the property. The conservation easements specifically prohibited the mining or extraction of sand, gravel, rock, or any other mineral. The taxpayers valued the easement donation under the "before and after method," treating the highest and best use before the donation as gravel mining. The Tax Court (Judge Wherry) held that the before highest and best use was agricultural, not mining.

> Where ... an asserted highest and best use differs from current use, the use must be reasonably probable and have real market value. ... "Any suggested use higher than current use requires both 'closeness in time' and 'reasonable probability'". *Hilborn v. Commissioner*, [85 T.C. 677, 689 (1985)]. Any proposed uses that "depend upon events or combinations of occurrences which, while within the realm of possibility, are not fairly shown to be reasonably probable" are to be excluded from consideration. *Olson v. United States*, 292 U.S. 246, 257 (1934).
>
> Where the asserted highest and best use of property is the extraction of minerals, the presence of the mineral in a commercially exploitable amount and the existence of a market "that would justify its extraction in the reasonably foreseeable future" must be shown. *United States v. 69.1 Acres of Land*, 942 F.2d 290, 292 (4th Cir. 1991). "There must be some objective support for the future

demand, including volume and duration. Mere physical adaptability to a use does not establish a market."

- Based on detailed examination of the facts and expert witness reports, the evidence did not prove that a hypothetical willing buyer in the year of the donation would have considered the land as the site for construction of a gravel mine. "While it would have been physically possible to mine the properties in 2004 (or in the future), there was no unfilled demand and there was no unmet market." Instead, Judge Wherry found that there were comparable sales upon which a before valuation of the contribution could be based. However, Judge Wherry declined to uphold the § 6662(b)(3) substantial valuation penalty asserted by the IRS because he found that the taxpayers relied in good faith on the appraisers and the accounting firm they hired as advisors.

4. **Judge Wells analyzed in detail the expert testimony concerning four donated conservation easements in the Columbus, Georgia area.** Butler v. Commissioner, T.C. Memo. 2012-72 (3/19/12). Taxpayers claimed about $10 million of charitable contribution deductions for four donated easements on large tracts of rural land located in the direction of the expansion of the city of Columbus, Georgia. The Tax Court (Judge Wells) allowed deductions totaling about $6.5 million. He analyzed in detail the reports and testimony of the appraisers for both taxpayers and the IRS in a lengthy opinion, including a consideration of the various appraisal methods used, particularly the discounted cash flow method, the comparable sales method and the so-called "comparable easements method." It also deals with the difference between the last two methods, the latter of which arrives at a percentage diminution in value caused by the donated easement.

- As an initial matter, the Tax Court (Judge Wells) concluded that the taxpayer had produced credible evidence as required by § 7491(a) with respect to the factual issues regarding whether their conservation easements satisfied the requirements of § 170(h), thus shifting the burden of proof to the IRS. The purposes of the easements were to provide a significant wildlife resource for the region and enhance the natural aesthetics of the area; the site offered forage, nesting habitat, and shelter; the public would be benefitted by cleaner air and water; plentiful game for hunting, and natural beauty in the area. Among the uses prohibited by the conservation easements were mineral exploitation, "commercial or industrial facilities (other than those necessary in the operation or uses of the property expressly permitted by the easements), dumping, billboards, commercial towers, and mobile homes or recreational vehicles." The conservation deeds did not permit the general public to access the properties. The conservation deeds reserved numerous rights for the taxpayer. The taxpayer (or future owners) could partition one of the properties into smaller tracts averaging 36 acres, each of which would include a 2-acre building site on which a home and a garage could be constructed and could build on one two-acre building site on the other property. Roads or driveways could be constructed to access the buildings. The taxpayer (or future landowners) could operate small-scale farms and could use agrichemicals to eliminate "noxious weeds" subject only to the exhortation that they "minimiz[e] the impact upon non-noxious foliage and vegetation." They could construct dams to create ponds for recreation or irrigation, and they could construct docks, gazebos, and "related recreational structures." They could clear timber for agricultural uses, clear brush and remove trees for "aesthetic" purposes, and plant nonnative species of trees or other plants. The conservation deeds also permitted a wide variety of other uses provided that those uses do not result in "demonstrable degradation to the conservation values," including the construction of fences, the construction of other roads besides those that access the building sites, the construction of an unlimited number of barns and sheds for agricultural or recreational use on any portion of the property (not just the two-acre building sites), and commercial timber harvesting pursuant to an approved timber management plan. The donee had the right to determine whether such uses would result in degradation to the conservation values. Judge Wells held that these reserved rights were not inconsistent with the conservation purpose and allowed the deduction. Even if fully exercised, the rights would not destroy the habitats and high-quality ecosystems on the property.

- Judge Wells refused to uphold substantial understatement penalties because taxpayers throughout the process had had "reasonable cause and acted in good faith" by relying on their long-term attorney and accountant. The attorney also helped taxpayers in selecting Conservation Advisors, L.L.C., a real estate firm specializing in conservation conveyances, which in turn helped them select qualified and experienced appraisers who "had access to sufficient information to value the conservation easements."

5. **The old adage "better late than never" didn't save the taxpayer's deduction for a conservation easement on mortgaged property.** Mitchell v. Commissioner, 138 T.C. No. 16 (4/3/12). In 2003, the taxpayer contributed a conservation easement over 180 acres of unimproved land to a qualified organization. The property was subject to a mortgage, the mortgagee did not subordinate the mortgage to the conservation easement deed until 2005. The taxpayer claimed a charitable contribution deduction on her 2003 Federal income tax return, which the IRS disallowed. The taxpayer argued that she had met the requirement of Reg. § 1.170A-14(g)(2) requiring subordination of a mortgage to the conservation easement because Reg. § 1.170A-14(g)(3) should apply to determine whether the requirements of Reg. § 1.170A-14(g)(2) had been satisfied. Reg. § 1.170A-14(g)(3) provides that a deduction will not be disallowed merely because on the date of the gift there is the possibility that the interest will be defeated so long as on that date the possibility of defeat is so remote as to be negligible. The taxpayer argued that the probability of her defaulting on the mortgage was so remote as to be negligible, and that the possibility should be disregarded under the so-remote-as-to-be-negligible standard in determining whether the conservation easement is enforceable in perpetuity. The Tax Court (Judge Haines) held that the so-remote-as-to-be-negligible standard of Reg. § 1.170A-14(g)(3) does not apply to determine whether the requirements of Reg. § 1.170A-14(g)(2), requiring subordination of a mortgage to the conservation easement have been satisfied, citing *Kaufman v. Commissioner*, 136 T.C. 294 (2011); *Kaufman v. Commissioner,* 134 T.C. 182 (2010); *Carpenter v. Commissioner*, T.C. Memo. 2012-1, and distinguishing *Simmons v. Commissioner,* T.C. Memo. 2009-208, *aff'd*, 646 F.3d 6 (D.C. Cir. 2011). Thus, the taxpayer did not meet the requirements of Reg. § 1.170A-14(g)(2) and the deduction was denied. However, the taxpayer was not liable for a § 6662 accuracy related penalty. She "attempted to comply with the requirements for making a charitable contribution of a conservation easement"; she hired an accountant and an appraiser, but she "inadvertently failed to obtained a subordination agreement" and "upon being made aware of the need for a subordination agreement she promptly obtained one." She acted with reasonable cause and in good faith.

6. **If the donee messes up on the written acknowledgement, your only recourse is to have the chaplain punch your Tare Sugar chit [Tango Sierra chit, if you were in the military after the 1950s] because Judge Cohen won't help you.** Durden v. Commissioner, T.C. Memo. 2012-140 (5/17/12). A letter from taxpayers' church, dated 1/10/08, acknowledged numerous contributions during 2007, mostly in amounts of $250 or more, totaling $22,517; however the letter lacked a statement that no goods or services were provided to taxpayers in exchange for their contributions. A second letter from the church contained that statement but was dated 6/21/09, after the IRS sent a notice of deficiency disallowing most of the claimed charitable contribution deductions. The Tax Court (Judge Cohen) held that the second letter was untimely and the first letter was insufficient, so the taxpayers' charitable contributions of $250 or more were disallowed under § 170(f)(8).

7. **You can't be your own appraiser, even if you might be qualified! "A taxpayer relies on his private interpretation of a tax form at his own risk."** Mohamed v. Commissioner, T.C. Memo. 2012-152 (5/29/12). The taxpayer, a real-estate broker and certified real-estate appraiser, donated five real estate properties worth millions of dollars to a charitable trust. The taxpayer prepared his own tax return, including the Form 8283, Noncash Charitable Contributions, claiming charitable contribution deductions of over $3,000,000, even though the properties were worth over $15,000,000. The taxpayer left blank the Declaration of Appraiser because it stated, "I declare that I am not the donor, the donee, a party to the transaction," and he recognized that he was the donor (and the donee, since he was trustee of the Trust), but he did sign the Donee Acknowledgment saying that the Trust was a qualified organization under

§ 170(c) and that the Trust had actually received the claimed donations. The taxpayer also attached two statements to the tax return. The first was captioned "Statement of Explanation for Entry on Line 6 of Schedule A," and gave the addresses of the properties, more detailed descriptions of their size and improvements, and values for the properties. The second one, titled "Appraised Market Values," elaborated on the appraisal. He signed the second document, and under his signature indicated that his title was "Real Estate Broker/Appraiser." In the course of an audit over valuation, the taxpayer hired an independent appraiser whose valuations were relatively consistent with the taxpayer's valuations, but the IRS thereupon asserted that no deduction was allowable for failure to comply with the Reg. § 1.170A-13(c) substantiation requirements, which among other things require a "qualified appraisal," which under the regulations cannot be the donor or taxpayer claiming the deduction or the donee of the property. The taxpayer thus was not a qualified appraiser, and his attachments to the tax return did not qualify as the required appraisal summary that must be attached to the return, because they failed to include information about several of the required categories on Forms 8283 and the attached statements. The Tax Court (Judge Holmes) granted summary judgment to the IRS, upholding the validity of the regulations — no surprise — and finding that the taxpayer had failed to satisfy the "substantial compliance" doctrine, because "[t]he cases make clear that substantial compliance requires a qualified appraisal," but excuses certain other minor deviations from the regulations requirements. Lastly, Judge Holmes rejected the taxpayer's "last-ditch effort" to save the deductions by arguing that Form 8283 for the years in question did not indicate that a taxpayer had to get an independent appraisal for contributions worth more than $5,000 and presented conflicting messages about what could be filled out by the taxpayer and what required an appraiser's signature. "We can't hold the form's failings against the Commissioner here, because 'the authoritative sources of Federal tax law are in the statutes, regulations, and judicial decisions and not in such informal publications.'"

8. According to Judge Wells, you can write your own acknowledgment of the donee's receipt of your charitable contribution. Averyt v. Commissioner, T.C. Memo. 2012-198 (7/16/12). The Tax Court (Judge Wells) held that a conservation easement deed reciting that the easement had been conveyed for "no consideration" satisfied the requirements of § 170(f)(8), even though the letter from the donee organization acknowledging the contribution did not satisfy § 170(f)(8) because it failed to state that no goods or services were received in exchange for the contribution. The letter recited that the taxpayer's sons had received "pens and pencils," which it was stipulated never had been received, but the letter nevertheless did not qualify, even though the pens and pencils would have had only nominal value, because the letters did not comply with the requirements of Rev. Proc. 90-12, § 2.05, 1990-1 C.B. 471, 472 (because the contribution was not pursuant to a fund-raising campaign).

- Section 170(f)(8)(B) provides that the contemporaneous written acknowledgment must include the following information: (i) The amount of cash and a description (but not value) of any property other than cash contributed; (ii) Whether the donee organization provided any goods or services in consideration, in whole or in part, for any property described in clause (i); (iii) A description and good faith estimate of the value of any goods or services referred to in clause (ii) *** Section 170(f)(8)(C) defines a "contemporaneous" acknowledgment as one received on or before the earlier of: (i) the date on which the taxpayer files a return for the year when the contribution was made; or (ii) the due date for that return, including any extensions.

9. A "gotcha" for the IRS! The Tax Court just says "no" to deductions for contributions of conservation easements on mortgaged properties. Kaufman v. Commissioner, 134 T.C. 182 (4/26/10). The Tax Court (Judge Halpern) held that as a matter of law no charitable contribution deduction is allowable for the conveyance of an otherwise qualifying conveyance of a facade conservation easement if the property is subject to a mortgage and the mortgagee has a prior claim to condemnation and insurance proceeds. Because the mortgage has priority over the easement, the easement is not protected in perpetuity – which is required by § 170(h)(5)(A). The deduction cannot be salvaged by proof that the taxpayer likely would satisfy the debt secured by the mortgage.

Back to Table of Contents

a. Plea for a mulligan is rejected! Kaufman v. Commissioner, 136 T.C. 294 (4/4/11). On the taxpayers' motion for reconsideration, the Tax Court (Judge Halpern) in a lengthy and thorough opinion reaffirmed its earlier decision that the conservation easement failed the perpetuity requirement in Reg. § 1.170A-14(g)(6), because under the loan documents, the bank that held the mortgage on the property expressly retained a "'prior claim' to all insurance proceeds as a result of any casualty, hazard, or accident occurring to or about the property and all proceeds of condemnation," and agreement also provided that "the bank was entitled to those proceeds 'in preference' to [the donee organization] until the mortgage was satisfied and discharged." The court also disallowed a deduction in 2003, but allowed the deduction in 2004, for a cash contribution to the donee of the conservation easement in 2003 because the amount of the cash payment was subject to refund if the appraised value of the easement was zero, and the appraisal was not determined until 2004. The court also rejected the IRS's argument that the taxpayers received a *quid pro quo* for the cash contribution in the form of the donee organization accepting and processing their application, providing them with a form preservation restriction agreement, undertaking to obtain approvals from the necessary government authorities, securing the lender agreement from the bank, giving the taxpayers basic tax advice, and providing them with a list of approved appraisers. The facts in evidence did not demonstrate a *quid pro quo*, because, among other things, many of the tasks had been undertaken by the organization before the check was received.

- Finally, the court declined to uphold the § 6662 accuracy related penalties asserted by the IRS for the taxpayer's overstatement of the amount of the contribution for the conservation easement, but sustained the negligence penalty for the 2003 deduction for the cash payment. Because the issue of whether any deduction was allowed for the easement, regardless of its value, was a matter of law decided in the case as a matter of first impression, the taxpayers were not negligent, had reasonable cause, and acted in good faith.

b. The taxpayer wins the battle in the Court of Appeals, but still might lose the war. Kaufman v. Commissioner, 109 A.F.T.R.2d 2012-____ (1st Cir. 7/19/12). The First Circuit, however, in an opinion by Judge Boudin, disagreed with the Tax Court, holding that a mortgagee's right to satisfy the mortgage lien before the donee of the conservation easement is entitled to any amount from the sales or condemnation proceeds from the property does not necessarily defeat the charitable contribution deduction. Judge Boudin's opinion noted that "the Kaufmans had no power to make the mortgage-holding bank give up its own protection against fire or condemnation and, more striking, no power to defeat tax liens that the city might use to reach the same insurance proceeds – tax liens being superior to most prior claims, 1 Powell on Real Property § 10B.06[6] (Michael Allan Wolf ed., Matthew Bender & Co. 2012), including in Massachusetts the claims of the mortgage holder."[4] The opinion continued by observing that

> [G]iven the ubiquity of super-priority for tax liens, the IRS's reading of its regulation would appear to doom practically all donations of easements, which is surely contrary to the purpose of Congress. We normally defer to an agency's reasonable reading of its own regulations, e.g., *United States v. Cleveland Indians Baseball Co.*, 532 U.S. 200, 220 (2001), but cannot find reasonable an impromptu reading that is not compelled and would defeat the purpose of the statute, as we think is the case here.

Thus, the First Circuit rejected the Tax Court's requirement that the donee of the conservation easement have "an absolute right" (136 T.C. at 313), holding that a "grant that is absolute against the owner-donor" is sufficient "and almost the same as an absolute one where third-party claims (here, the bank's or the city's) are contingent and unlikely."

- The First Circuit went on to reject the IRS's argument that contribution also failed to qualify for a charitable contribution deduction because provision in the

[4] We include the citation to Powell on Real Property in the quotation because Michael Allan Wolf is a colleague of Professor McMahon's and the UF Dean rewards faculty members based, in part, on their citation count.

Back to Table of Contents

agreement between the Kaufmans and the donee trust stated that "nothing herein contained shall be construed to limit the [Trust's] right to give its consent (e.g., to changes in the Façade) or to abandon some or all of its rights hereunder," citing *Commissioner v. Simmons*, 646 F.3d 6 (D.C. Cir. 2011), which reasoned that such clauses permitting consent and abandonment "have no discrete effect upon the perpetuity of the easements." "'Any donee might fail to enforce a conservation easement, with or without a clause stating it may consent to a change or abandon its rights, and a tax-exempt organization would do so at its peril....'" (citing 646 F.3d at 10).

- The court also rejected various scattershot IRS arguments that the substantiation rules had not been met.

- However, the Court of appeals did not necessarily hand the taxpayers a final victory. It remanded the case to the Tax Court on the valuation issue.

> When the Kaufmans donated the easement, their home was already subject to South End Landmark District rules that severely restrict the alterations that property owners can make to the exteriors of historic buildings in the neighborhood. These rules provide that "[a]ll proposed changes or alterations" to "all elements of [the] facade, ... the front yard ... and the portions of roofs that are visible from public streets" will be "subject to review" by the local landmark district commission.
>
> Under the Standards and Criteria, property owners of South End buildings have an obligation to retain and repair the original steps, stairs, railings, balustrades, balconies, entryways, transoms, sidelights, exterior walls, windows, roofs, and front-yard fences (along with certain "other features"); and, when the damaged elements are beyond repair, property owners may only replace them with elements that look like the originals. Given these pre-existing legal obligations the Tax Court might well find on remand that the Kaufmans' easement was worth little or nothing.

- The court took note of the fact that in persuading the Kaufmans to grant the easement, "a Trust representative told the Kaufmans that experience showed that such easements did not reduce resale value, and this could easily be the IRS's opening argument in a valuation trial."

10. Contributions to a disregarded entity owned by a charity. Notice 2012-52, 2012-__ I.R.B. __ (7/31/12). This Notice holds that the IRS will treat a contribution to a disregarded single member LLC that is wholly owned and controlled by a U.S. charity as a charitable contribution to a branch or division of the U.S. charity.

X. TAX PROCEDURE

A. Interest, Penalties and Prosecutions

1. The instructions for the new FBAR are FUBAR. IR-2009-58 and Announcement 2009-51, 2009-1 C.B. 1105 (6/5/09). The IRS announced that for the Reports of Foreign Bank and Financial Accounts (FBARs) due on 6/30/09, filers of Form TD F 90-22.1 (Rev. 10-2008) need not comply with the new instruction relating to the definition of a United States Person, i.e.:

> **United States Person.** The term "United States person" means a citizen or resident of the United States, or a person in and doing business in the United States. See 31 C.F.R. 103.11(z) for a complete definition of 'person.' The United States includes the states, territories and possessions of the United States. See the definition of United States at 31 C.F.R. 103.11(nn) for a complete definition of United States. A foreign subsidiary of a United States person is not required to file this report, although its United States parent corporation may be required to do so. A branch of a foreign entity that is doing business in the United States is required to file this report even if not separately incorporated under U.S. law.

- Instead, for this year, taxpayers and others can rely on the definition of a United States person included in the instruction to the prior form (7-2000):

United States Person. The term "United States person" means: (1) a citizen or resident of the United States; (2) a domestic partnership; (3) a domestic corporation; or (4) a domestic estate or trust.

a. Notice 2009-62, 2009-2 C.B. 260 (8/7/09). By this notice, the IRS extended the filing deadline until 6/30/10 to report foreign financial accounts on Form TD F 90-22.1 for persons with signature authority over (but no financial interest in) a foreign financial account and persons with signature authority over, or financial interests in, a foreign commingled fund.

b. **Still clear as mud: New definitions and instructions.** RIN 1506-AB08, Financial Crimes Enforcement Network; Amendment to the Bank Secrecy Act Regulations – Reports of Foreign Financial Accounts, 75 F.R. 8844 (2/26/10). This proposed rule would include a definition of "United States person" and definitions of "bank account," "securities account," and "other financial account," as well as of "foreign country." It also includes draft instructions to Form TD F 90-22.1 (FBAR).

(1) Notice 2010-23, 2010-1 C.B. 441 (2/26/10). Provided administrative relief to certain person who may be required to file an FBAR for the 2009 and earlier calendar years by extending the filing deadline until 6/30/11 for persons with signature authority, but no financial interest in, a foreign financial account for which an FBAR would have otherwise been due on 6/30/10. It also provides relief with respect to mutual funds.

(2) Announcement 2010-16, 2010-1C.B. 450 (2/26/10). The IRS suspended, for persons who are not U.S. citizens, U.S. residents, or domestic entities, the requirement to file an FBAR for the 2009 and earlier calendar years.

c. **Second (or, is it the third?) special voluntary disclosure initiative available through 8/31/11.** IR-2011-14 (2/8/11). The 2011 Offshore Voluntary Disclosure Initiative is similar to the 2009 Offshore Voluntary Disclosure Program with a 25-percent penalty and an 8-year look-back requirement (both slightly-increased from 2009). There are lower penalties in some limited situations (5 percent), and where offshore accounts do not surpass $75,000 (12.5 percent). All original and amended tax returns must be filed and payment of all taxes, interest and penalties must be made by the 8/31/11 deadline.

- Subsequent Q&As offer the possibility of a 90-day extension to complete the voluntary disclosure where total compliance had not been made by the deadline despite good faith attempts. See Q&A 25.1.

d. **Additional relief for persons with signature authority.** Notice 2011-54, 2011-29 I.R.B. 53_ (6/16/11). Provides additional relief to persons whose requirement to file Form TD-F 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR), for calendar year 2009 or earlier calendar years was based solely upon signature authority. Their deadline is now 11/1/11. The deadline for reporting signature authority over, or a financial interest in, foreign financial accounts for the 2010 calendar year was 6/30/11.

- Reporting problems occur for former employees, as well as with respect to foreign accounts that give signature authority to "all officers."

e. **Complying with FATCA may cause tax return preparers to become confused.** IR-2011-117 (12/14/11). An information return on Form 8938 must be filed by individuals with more than the threshold amount for foreign financial assets. It will serve as a check on foreign financial institutions providing Form 1099 with respect to income from such assets.

f. **And the proposed FATCA regulations place an unwanted burden on foreign financial institutions to the point that many of them refuse to open accounts for U.S. citizens.** REG-121647-10, Regulations Relating to Information Reporting by Foreign Financial Institutions and Withholding on Certain Payments to Foreign Financial Institutions and Other Foreign Entities, 77 F.R. 9022 (2/15/12). Proposed regulations under §§ 1471 through 1474, regarding information reporting by foreign financial institutions (FFIs) with respect to U.S. accounts and withholding on certain payments to FFIs and other foreign entities. These regulations affect persons making certain U.S.-related payments to FFIs and other foreign entities and payments by FFIs to other persons.

g. ♪♫ "This is a song that doesn't end. / It goes on and on, my friend …." ♫♪ Third (or fourth) voluntary disclosure program is announced. IR-2012-5 (1/9/12). The IRS has announced the reopening of the offshore voluntary disclosure program (OVDP) following the closure of the 2011 and 2009 programs. There is no set deadline within which to apply, but the program could be changed or terminated at any time. The penalty structure for the program will be similar to the 2011 program except the highest penalty will be 27.5 percent instead of 25 percent. Details are available on the IRS website.

2. "Same taxpayer" really does mean the same taxpayer. Energy East Corp v. United States, 645 F.3d 1358 (6/20/11). Section 6621(d) deals with overlapping periods of underpayment and overpayment by the "same taxpayer" by imposing a net interest rate of zero on the equivalent underpayment and overpayment for the period of the overlap. Energy East Corporation filed a refund claim, seeking to offset the amount it underpaid in 1999 with amounts two of its subsidiaries overpaid from 1995–97, even though consolidation did not occur until 2000 and 2002. The Court of Appeals for the Federal Circuit (Judge Gajarsa) held that § 6621(d) did not apply in this situation. The parent and the subsidiaries were not the same taxpayer in the pre-consolidation years that the underpayments and overpayments were made. The court rejected the taxpayer's argument that § 6621(d) merely requires the taxpayers to be the same only as of the time the netting claim was filed. The court rejected the taxpayer's alternative argument that § 6621(d) allows interest netting when two or more corporations file consolidated returns for years during which interest accrues.

a. But a particular corporation is the "same taxpayer" after it joins a consolidated group as it was before it joined the consolidated group, even though *Energy East* is law of the Circuit. Magma Power Co. v. United States, 101 Fed. Cl. 562 (10/28/11). Prior to 2/24/95, Magma Power was not part of a consolidated group. In 2000 Magma Power was assessed a deficiency for 1993, which it paid in 2002 and 2003. In 2004 and 2005, the IRS determined that the consolidated group of which Magma Power was a member overpaid its taxes for the years 1995-1998 and paid a refund. A portion of the refund for those years was attributable to an original overstatement of Magma Power's contribution to consolidated taxable income. The Court of Federal Claims (Judge Baskir) held that for purposes of applying the interest netting rule of § 6621(d), Magma Power was the "same taxpayer" with respect to its underpayment for 1993, before it joined a consolidated group and with respect to the consolidated group's overpayments for the period of 1995 through 1998. The court rejected the government's argument that the "plain meaning" of § 6621(d) "contemplates a complete identity between the entities reflected on the tax returns in question, regardless of which specific taxpayers are responsible for underpayments and overpayments," reasoning – correctly in our opinion – that the group is not a "taxpayer" under the Code. The court distinguished *Energy East Corp v. United States*, 645 F.3d 1358 (Fed. Cir. 6/20/11), *supra*, because the overpayments and underpayments in that case related to different corporations and were with respect to pre-consolidation years.

3. The Treasury explains the penalty for failing to rat yourself out regarding reportable transactions. T.D. 9550, Section 6707A and the Failure To Include on Any Return or Statement Any Information Required To Be Disclosed Under Section 6011 With Respect to a Reportable Transaction, 76 F.R. 55256 (9/7/11). Reg. § 301.6707A-1 provides that a taxpayer may incur a separate penalty under § 6707A with respect to each reportable transaction that the taxpayer was required, but failed, to disclose within the time and in the form and manner required under Reg. § 1.6011-4(d) and (e) or as stated in other published guidance. A taxpayer who is required to disclose a reportable transaction on a Form 8886 (or successor form) filed with a return, amended return, or application for tentative refund and who also is required to disclose the transaction on a Form 8886 (or successor form) with the Office of Tax Shelter Analysis (OTSA), is subject to only a single § 6707A penalty for failure to make either one or both of those disclosures. The regulations define "reportable transaction" and "listed transaction" by reference to the regulations under § 6011.

4. If you're the guy who doesn't remit the wage withholding taxes to the IRS, you can't claim a credit for taxes withheld, and you might be hit with a fraud penalty to boot. May v. Commissioner, 137 T.C. 147 (10/24/11). The taxpayer was the CEO and president, as well as a shareholder of his employer. The employer corporation withheld taxes from paychecks, but did not remit the taxes to the government. The taxpayer nevertheless claimed credit of the withheld taxes on his own return. Following the taxpayer's conviction for criminal tax fraud, the IRS asserted a deficiency, and the taxpayer filed a Tax Court petition. The Tax Court (Judge Goeke) held, first, that the Tax Court has jurisdiction over fraud penalties in a case involving a deficiency based on overstated withholding credits, citing *Rice v. Commissioner*, T.C. Memo. 1999-65. The Tax Court had jurisdiction over the case as involving a "deficiency" because an "underpayment" includes a taxpayer's overstated credits for withholding under *Feller v. Commissioner*, 135 T.C. 497 (2010). The court rejected the taxpayer's argument that under Reg. § 1.31-1 which provides that "[i]f the tax has actually been withheld at the source, credit or refund shall be made to the recipient of the income even though such tax has not been paid over to the Government by the employer." Instead, following *United States v. Blanchard*, 618 F.3d 562 (6th Cir. 2010), it concluded that "the proper test to determine whether actual withholding at the source occurred should consider whether the funds functionally left the control of a taxpayer. Such a test should not be strictly constrained by the multiple identities one person may have when acting in both a personal and a corporate capacity." On the facts, "[b]ecause Mr. May was responsible for the nonremittance and fully controlled the corporate finances," the court concluded that "that the funds never left Mr. May's functional control and were therefore not 'actually withheld at the source' from his wages." Furthermore, the IRS carried its burden of proof on the fraud issue and the 75-percent fraud penalty was justified with respect to the underpayments resulting from overstated withholding credits.

5. A careful reading of this criminal tax fraud case should put the fear of God, or at least of the CID and DOJ, in the hearts of many tax shelter investors. United States v. Rozin, 664 F.3d 1052 (6th Cir. 1/6/12). The Sixth Circuit, in an opinion by Judge Rogers, upheld the defendant's conviction for criminal tax fraud. The defendant had claimed business and individual tax deductions for the cost of so-called "loss of income" (LOI) insurance policies, although the insurance aspect of the policies was questionable, and the policies allegedly permitted the defendant to reclaim or maintain control of the amount paid as premiums. The LOI policies insured against loss of income due to certain circumstances, including corporate downsizing, changes in technology, or employee layoffs arising within one year from the date the policy was issued, but did not cover death; disability; voluntary termination; self-inflicted injuries; proven criminal acts; negligent or willful misconduct; substance abuse; dishonesty or fraud; insubordination, incompetence, or inefficiency; conflict of interest; or breach of employment contract. In conjunction with the LOI insurance policy, the defendant also purchased from the same "return of premium" (ROP) riders. If no claim was filed on the LOI policy, under the rider the LOI premium would be invested for the policy owner and would be distributed to the owner after ten years or at age sixty-five. According to the promotional materials, the LOI premium payments (but not the rider) were deductible. In convicting the defendant of tax evasion and conspiracy to defraud the IRS, the District Court noted:

> (1) the lack of a "true business purpose for purchasing the various LOI policies," (2) the "dubious nature" of the policies, including the high premium to coverage ratio, as well as the practice of backdating, (3) Rozin's access to and control over the funds, (4) Rozin's descriptions of the policies to [friends to whom he recommended the scheme] as "tax-savings product[s]," and (5) the differences between the policies Rozin bought and those that were advertised in [the insurance broker's] promotional materials.

The District Court held that "Rozin did not have a good faith reliance defense because he withheld relevant information and had reason to suspect the motives of the individuals on whom he supposedly relied." In upholding the conviction, the Court of Appeals made the following points:

Back to Table of Contents

(1) "Though peddled as 'insurance,' ... the covered risks – corporate downsizing, employee layoffs, and technological obsolescence – were unlikely to happen to Rozin because he was an owner of a carpet company. Many of the most obvious causes of loss of income, such as death, disability, voluntary termination, and breach of contract, were not covered, and Rozin, Inc. was not under any immediate threat of bankruptcy." In addition, unlike other legitimate insurance policies, Rozin maintained control of the funds; when pitching the LOI policies to potential buyers, Rozin described them as "a way to lower your taxes" while also receiving "a large percentage of that money back."

(2) "[B]ackdating the LOI policies showed willfulness, because there was no reason for such backdating other than to claim the improper tax deductions."

(3) "When selling the LOI policies to friends, Rozin stated outright that about eighty-five percent of the money would 'come back and be held in a trust' that the individual would 'have control over.' Evidence that Rozin knew that he would have access to most of his money, while reaping the benefits of a large tax deduction, would permit a rational trier of fact to find that he willfully utilized the LOI policies in order to evade taxes."

(4) "Because Rozin either did not provide full information to those he supposedly relied upon, or he had reason to believe that the advice provided by these individuals was incorrect, the district court correctly held that Rozin could not mount a credible good faith reliance defense."

(5) "Because [the CPA who prepared the tax returns] was not aware of the full facts regarding the LOI policies, Rozin cannot claim that he relied on [his] advice in good faith."

(6) " ... Rozin did not rely on Cohen, let alone rely on Cohen in good faith. ... Cohen also told Rozin that if the IRS did 'challenge the deduction,' the worst thing that Rozin would have to do would be to pay the taxes owed plus interest. Noting the possibility that the IRS could challenge the deduction should have raised a red flag for Rozin, giving him reason to suspect that the information Cohen provided him was incorrect. In addition ... Cohen's motivations were at least suspect because he received commissions from the sale of the LOI policies."

- If those "factors" don't describe a lot of tax shelter investors to a "T," we don't know what does!

6. Hiding funds to try to cheat creditors isn't the same as hiding them to try to cheat the IRS, even if the effect is the same. Avenell v. Commissioner, T.C. Memo. 2012-32 (2/2/12). The taxpayer diverted funds from the corporation (Tacon) of which he was the president and a 96 percent shareholder. The primary issue in the case was not whether he was liable for income taxes on the diverted funds, but whether he was liable for the civil tax fraud penalty. The taxpayer, represented by Larry Sherlock of the Chamberlain Hrdlicka firm, argued that he did not divert the funds with intent to evade tax but rather to hide the funds from a judgment creditor of the corporation. Even though part of the taxpayer's behavior included the use of a Cayman Island bank account, Judge Kroupa held that the IRS had failed to prove fraud by clear and convincing evidence. She reasoned that "he did not understand that Tacon was a separate entity and that Tacon's funds were different and separate from his own. ... [S]pending company funds for personal use is not per se fraudulent. ... [P]etitioner's actions stemmed from an intent to avoid judgment collection coupled with a lack of sophistication about and attention to legal obligations and financial details."

7. Inconsistent Forms 1099 from year to year for the same payment give rise to a "reasonable cause" defense to accuracy related penalties. Sewards v. Commissioner, 138 T.C. No. 15 (4/2/12). The taxpayer, who had been a policeman until he retired following a service related injury, was eligible for two types of retirement plans: (1) a service retirement based on his length of service (service retirement) and (2) a service-connected disability retirement based on his service-connected injuries (SCD retirement). Under the SCD plan a policeman was eligible for a benefit equal to the greater of (1) one-half of final salary, or (2) the service retirement benefit. One half of the taxpayer's salary was $7,046 annually while the service benefit was $12,861. The taxpayer originally received 2001 and 2002 Forms 1099-R indicating that his service retirement payments were fully taxable. After his SCD retirement became effective, he received amended 2001 and 2002 Forms 1099-R indicating that the taxable amount was not determined. He subsequently received 2003, 2004, and 2005 Forms 1099-R also indicating that the taxable amount was not determined. A letter dated December 20, 2006, notified the taxpayer that beginning in 2006 benefits equal to 50% of his final compensation would be reported as taxable, and he received a 2006 Form 1099-R indicating a portion of his SCD retirement payments was taxable, but the taxpayer did not report any of his benefits as taxable income. The Tax Court (Judge Foley) held that an amount equal to the minimum payment under the SCD retirement plan — one-half of final salary — was excludable under § 104(a)(1) as an amount received pursuant to a workmen's compensation act or a statute in the nature of a workmen's compensation act. But the remaining benefit was not excludable because it was determined by reference to the employee's age or length of service, citing Reg. § 1.104-1(b). However, Judge Foley declined to uphold the § 6662 accuracy related penalties imposed by the IRS. He held that the taxpayer had reasonable cause because over the course of several years the Forms 1099 varied.

8. **Filing a false return or aiding and abetting the filing of a false return by a lawful permanent resident alien carries a really stiff penalty. Bye-bye America!** Kawashima v. Holder, 132 S. Ct. 1166 (2/21/12). In a 6-3 decision written by Justice Thomas, the Supreme Court held that a lawful permanent resident alien could be deported as a result of conviction of willfully making and subscribing a false (not necessarily fraudulent) tax return, which is a criminal offense under § 7206(1), or a conviction for aiding and assisting in the preparation of a false tax return, which is a criminal offense under § 7206(2). The convictions qualified as crimes involving fraud or deceit under 8 U.S.C. § 1101(a)(43)(M)(i) (Clause (i)) and thus were aggravated felonies for which the taxpayers could be deported under 8 U.S.C.§ 1227(a)(2)(A)(iii).

- Justice Ginsburg's dissenting opinion makes a great deal of sense.

9. **The Steve Martin excuse[5] doesn't work in the Seventh Circuit. Failure to file for nearly twenty years isn't mere negligence.** United States v. Collins, 685 F.3d 651 (7th Cir. 7/6/12). The defendant, who failed to file income tax returns for almost twenty years, was convicted of tax evasion. On appeal, he argued that the use of the Seventh Circuit pattern jury instructions for tax evasion was erroneous because they did not distinguish the crime of tax evasion from a "mere negligent failure to file a tax return." The Court of Appeals (Judge Sykes) affirmed, stating that "it's not remotely plausible to attribute a tax delinquency of almost two decades to mere negligence." A jury does not need to "be specifically instructed that 'willful' tax evasion requires more than a mere negligent failure to file a return."

B. Discovery: Summonses and FOIA

1. **You can't hide your foreign bank account records behind the Fifth Amendment**. M.H. v. United States, 648 F.3d 1067 (9th Cir. 8/19/11), *cert. denied* (6/25/12). M.H. was the target of a grand jury investigation seeking to determine whether he used secret Swiss bank accounts to evade paying federal taxes. The District Court granted a motion to compel his compliance with a grand jury subpoena *duces tecum* demanding that he produce certain records related to his foreign bank accounts. The District Court declined to condition its order compelling production upon a grant of limited immunity and, pursuant to the recalcitrant witness statute, 28 U.S.C. § 1826, held him in contempt for refusing to comply. The Ninth Circuit upheld the District Court order. The Court of Appeals held that "[b]ecause the records sought through the subpoena fall under the Required Records Doctrine, the Fifth Amendment privilege against self-incrimination is inapplicable, and M.H. may not invoke it to resist compliance with the subpoena's command." The records were required to be kept pursuant to the predecessor of 31 C.F.R. § 1010.420.

a. **When the government asks, ya gotta pony up the name(s) on your foreign bank accounts, the account numbers, the name and address of the banks, the type of account, and the maximum value of each such account during each year.** In re:

[5] "I forgot."

Back to Table of Contents

Special February 2011-1 Grand Jury Subpoena Dated September 12, 2011, ___ F.3d ___ (7th Cir. 8/27/12). In an opinion by Judge Bauer, the Seventh Circuit held that the compulsory production of foreign bank account records required to be maintained under the Bank Secrecy Act of 1970 does not violate a taxpayer's Fifth Amendment privilege against self-incrimination. The required records doctrine overrode any act of production privilege. A grand jury subpoena seeking his bank records issued in connection with an investigation into whether he used secret offshore bank accounts to evade his federal income taxes was enforced.

C. Litigation Costs

1. Shades of the nineteenth century. A written opinion in a case with $71 dollars at stake. Dale v. Commissioner, T.C. Memo. 2012-146 (5/22/12). In a case in which the IRS conceded that the taxpayer was entitled to attorney's fees under § 7430, Judge Kroupa held that a taxpayer may not recover "costs for secretarial and clerical work performed by a secretary ($37.50), an assistant ($23) and a 'staff' member ($10.50) (collectively, fees at issue)" that were not subsumed in the attorney's hourly rate.

D. Statutory Notice of Deficiency

1. The Eleventh Circuit reverses the Tax Court by reading Webster's Third New International Dictionary. Shockly v. Commissioner, 110 A.F.T.R.2d 2012-___ (11th Cir. 7/11/12). The Court of Appeals for the Eleventh Circuit (Judge Hull) reversed a Tax Court decision, T.C. Memo. 2011-97, in which the Tax Court held that if it determines that the deficiency notice with respect to which the petition was filed is invalid, then the period of limitations is not suspended. The Court of Appeals reasoned that the proposition that limiting this holding to only petitions filed in response to a valid deficiency notice "cannot be found on the face of the suspension statute, nor can it be squared with the plain language of the statute."

> Here, the breadth of § 6503(a)(1)'s plain language indicates the 2005 petition qualifies as a "proceeding in respect of the [SCC] deficiency." First, the proceeding need only be "in respect of" the deficiency, not seeking "a redetermination of" the deficiency. The phrase "in respect of" is particularly comprehensive, with one dictionary ascribing a definition of "as to; as regards; insofar as concerns; [or] with respect to." Webster's Third New International Dictionary 1934 (1993); cf. Kosak v. United States, 465 U.S. 848, 854, 104 S. Ct. 1519, 1523 (1984) (describing the phrase "arising in respect of" in a section of the Federal Tort Claims Act, 28 U.S.C. § 2680(c), as "encompassing"). This choice of phrase is in contrast to a closely related statute, § 6213(a), where Congress selected the more specific phrase "redetermination of" the deficiency. In our view, the phrase "in respect of" in § 6503(a)(1) requires only that the substance of the proceeding concern the deficiency.

- Presumably, the Tax Court will continue to follow its own precedent in future cases that are not appealable to the Eleventh Circuit.

E. Statute of Limitations

1. The courts hold that overstating basis is not the same as understating gross income, but the Treasury Department ultimately plays its trump card by promulgating regulations. Section 6501(e)(1) extends the normal three-year period of limitations to six years if the taxpayer omits from gross income an amount in excess of 25 percent of the gross income stated in the return. Section 6229(c)(2) provides a similar extension of the statute of limitations under § 6229(a) for assessments arising out of TEFRA partnership proceedings. A critical question is whether the six year statute of limitations applies if the taxpayer overstates basis and as a consequence understates gross income.

a. The Tax Court says overstating basis is not the same as understating gross income. Bakersfield Energy Partners, LP v. Commissioner, 128 T.C. 207 (6/14/07). The taxpayer overstated basis, resulting in an understatement of § 1231 gain. Looking to Supreme Court precedent under the statutory predecessor of § 6501(e) in the 1939 Code (*Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958)), from which the six-year statute of limitations in § 6229(c)(2) is derived and to which it is analogous, the Tax Court concluded that

Back to Table of Contents

this understated gain was not an omission of "gross income" that would invoke the six-year statute of limitations under § 6229(c)(2) applicable to partnership audits.

b. The Ninth Circuit likes the way the Tax Court thinks: *Bakersfield Energy Partners* is affirmed. Bakersfield Energy Partners, LP v. Commissioner, 568 F.3d 767 (9th Cir. 6/17/09). The Ninth Circuit affirmed the Tax Court on the grounds that the language at issue in the instant case was the same as the statutory language interpreted in *Colony*. The court noted, however, that "[t]he IRS's interpretation of § 6501(e)(1)(A) is reasonable."

c. And a judge of the Court of Federal Claims agrees. Grapevine Imports, Ltd v. United States, 77 Fed. Cl. 505 (7/17/07), *rev'd*, 636 F.3d 1368 (Fed. Cir. 3/11/11). In a TEFRA partnership tax shelter case, the Court of Federal Claims (Judge Allegra) held that the § 6501(e) six-year statute of limitations does not apply to basis overstatements, citing *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958). Section 6501(e), rather than § 6229(c)(2) as in *Bakersfield Energy Partners, LP*, applied because in earlier proceedings in the instant case (71 Fed. Cl. 324 (2006)), the court had held that § 6229 did not create an independent statute of limitations, but instead only provides a minimum period for assessment for partnership items that could extend the § 6501 statute of limitations, and because the FPAA was sent within this six-year statute of limitations under § 6229(d) the statute of limitations with respect to the partners was suspended.

d. But a District Court in Florida disagrees. Brandon Ridge Partners v. United States, 100 A.F.T.R.2d 2007-5347 (M.D. Fla. 7/30/07). The court refused to follow *Bakersfield Energy Partners* and *Grapevine Imports* and held that the § 6501(e) 6-year statute of limitations does apply to basis overstatements. The court reasoned that as a result of subsequent amendments to the relevant Code sections, the application of *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958) is limited to situations described in § 6501(e)(1)(A)(i), which applies to trade or business sales of goods or services. ["In the case of a trade or business, the term 'gross income' means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services."] The court reasoned that to conclude otherwise would render § 6501(e)(1)(A)(i) superfluous. Because the transaction at issue was the partnership's sale of stock, which was not a business sale of goods or services, the gross receipts test did not apply. On the facts, the partners and partnership returns (and statements attached thereto), taken together "failed to adequately apprise the IRS of the true amount of gain on the sale of the ... stock." Thus, the partnership did not show that the extended limitations period was inapplicable.

e. And a different judge of the Court of Federal Claims agrees with the District Court in Florida and disagrees with the prior Court of Federal Claims opinion by a different judge in *Grapevine Imports*. Salman Ranch Ltd. v. United States, 79 Fed. Cl. 189 (11/9/07). The court (Judge Miller) refused to follow *Bakersfield Energy Partners* and *Grapevine Imports* and held that the § 6501(e) six-year statute of limitations does apply to basis overstatements. Judge Miller reasoned that an understatement of "gain" is an omission of gross income, and that omission can result from a basis overstatement as well as from an understatement of the amount realized. Like the *Brandon Ridge Partners* court, Judge Miller concluded that the application of *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958), is limited to situations described in § 6501(e)(1)(A)(i), which applies to trade or business sales of goods or services. ("In the case of a trade or business, the term 'gross income' means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services.") Because the transaction at issue was the partnership's sale of a ranch, which was not a business sale of goods or services, the gross receipts test did not apply. On the facts, the partners' and partnership returns failed to adequately apprise the IRS of the amount of gain in a variant of the Son-of-Boss tax shelter. Accordingly, the partnership did not show that the extended limitations period was inapplicable. The amended order certified an interlocutory appeal and stayed the case pending further court order, because of the split of opinion between *Salman Ranch*, on the one hand, and *Bakersfield Energy Partners* and *Brandon Ridge Partners*, on the other hand.

f. **And the pro-government opinion by Judge Miller is slapped down by the Federal Circuit.** Salman Ranch Ltd. v. United States, 573 F.3d 1362 (Fed. Cir. 7/30/09). Following *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958), the Federal Circuit (Judge Schall, 2-1) held that "omits from gross income an amount properly includable therein" in § 6501(e)(1)(A) does not include an overstatement of basis. Accordingly, the six-year statute of limitations on assessment did not apply – the normal three-year period of limitations applied. Judge Newman dissented.

g. **But a second District Court sees it the government's way.** Home Concrete & Supply, LLC v. United States, 599 F. Supp. 2d 678 (E.D. N.C. 10/21/08), *rev'd*, 634 F.3d 249, *aff'd*, 132 S. Ct. 1836 (4/25/12). The court held that §6501(e) extends the statute of limitations for deficiencies attributable to basis overstatements that result in omitted gross income exceeding 25 percent of the gross income reported on the return. The court refused to follow the Tax Court's decisions in *Bakersfield Energy Partners* and *Grapevine Imports*, because it concluded that those cases were erroneously decided.

h. **A hiccup from Judge Goeke in the Tax Court: Overstated basis in an abusive tax shelter is a substantial omission from gross income that extends the statute of limitations.** Highwood Partners v. Commissioner, 133 T.C. 1 (8/13/09). The taxpayers invested through partnerships in foreign currency digital options contracts designed to increase partnership basis and generate losses marketed by Jenkens & Gilchrist (Son of Boss and miscellaneous other names). After expiration of the three-year statute of limitations, the IRS issued an FPAA to the partnership based on the six-year statute of §6501(e)(1) applicable if there was a greater than 25 percent omission of gross income on each partner's or the partnership's return. The court (Judge Goeke) held that the digital options contracts produced § 988 exchange gain on foreign currency transactions, which, under the regulations, are required to be separately stated. The long and short positions of the options contracts were treated as separate transactions. Thus, failure to report the gain on the short position, not offset by losses on the accompanying stock sale, represented an omission of gross income. The court also rejected the taxpayer's argument that because the IRS asserted that the options transactions should be disregarded in full, there can be no omission of gross income from the disregarded short position. Finally, the court refused to apply the adequate disclosure safe harbor of § 6501(e)(1)(A)(ii) because the taxpayer's netting of the gain and loss from the long and short positions was intended to mislead and hide the existence of the gain and did not apprise the IRS of the existence of the gain.

i. **But Judge Haines follows the Tax Court orthodoxy.** Beard v. Commissioner, T.C. Memo. 2009-184 (8/11/09), *rev'd*, 633 F.3d 616 (7th Cir. 1/26/11). In a basis offset deal involving contributions of long and short positions in Treasury notes contributed to S corporations, the court (Judge Haines) granted summary judgment to the taxpayer holding that the basis overstatement attributable to the short sale was not an a substantial omission of gross income. Because the transaction involved Treasury notes, there were no § 988 issues involved. This holding is consistent with *Bakersfield Energy Partners v. Commissioner*, 568 F.3d 767 (9th Cir. 6/17/09), and *Salman Ranch Ltd. v. United States*, 573 F.3d 1362 (Fed. Cir. 7/30/09).

j. **And the IRS loses again in the Tax Court.** Intermountain Insurance Service of Vail v. Commissioner, T.C. Memo. 2009-195 (9/1/09). The court (Judge Wherry), again following *Bakersfield Energy Partners LP v. Commissioner*, 128 T.C. 207 (2007), granted summary judgment to the taxpayer holding that a basis overstatement is not a substantial omission from gross income that triggers the six-year extended statute of limitations under § 6229.

k. **Finally, the IRS gets the upper hand with temporary regulations.** T.D. 9466, Definition of Omission from Gross Income, 74 F.R. 49321 (9/24/09). Temp. Reg. §§ 301.6229(c)(2)-1T and 301.6501(e)-1T both provide that for purposes of determining whether there is a substantial omission of gross income, gross income as it relates to a trade or business includes the total amount received from the sale of goods or services, without reduction for the cost of goods sold, gross income otherwise has the same meaning as under § 61(a). The regulations add that, "[i]n the case of amounts received or accrued that relate to the

Back to Table of Contents

disposition of property, and except as provided in paragraph (a)(1)(ii) of this section, gross income means the excess of the amount realized from the disposition of the property over the unrecovered cost or other basis of the property. Consequently, except as provided in paragraph (a)(1)(ii) of this section, an understated amount of gross income resulting from an overstatement of unrecovered cost or other basis constitutes an omission from gross income for purposes of section 6229(c)(2)."

l. **But the IRS still suffers from a hangover in cases on which the extended statute had run before the effective date of the regulations.** UTAM, Ltd v. Commissioner, T.C. Memo. 2009-253 (11/9/09), *rev'd*, 645 F.3d 415 (D.C. Cir. 6/21/11). Judge Kroupa followed Bakersfield Energy Partners to hold that the statute of limitations is not extended to six years pursuant to § 6229(c)(2) or § 6501(e)(1)(A) as a result of a basis overstatement that causes gross income to be understated by more than 25 percent.

- Although the date of the decision was after the effective date of Temp. Reg. §§ 301.6229(c)(2)-1T and 301.6501(e)-1T, the result was dictated by prior law effective when the FPAA was issued in 1999.

m. **Judge Wherry shoves it up the Commissioner all the way to his "*Colon(-y)*" in a reviewed Tax Court decision that holds the Temporary Regulations invalid.** Intermountain Insurance Service of Vail v. Commissioner, 134 T.C. 211 (5/6/10) (reviewed, 7-0-6), *supplementing* T.C. Memo. 2009-195 (9/1/09) (granting summary judgment to the taxpayer, holding that a basis overstatement is not a substantial omission from gross income that triggers the six year extended statute of limitations under § 6229), *rev'd*, 650 F.3d 691 (D.C. Cir. 6/21/11). On the IRS's motions to reconsider and vacate in light of Temp. Reg. §§ 301.6229(c)(2)-1T and 301.6501(e)-1T, the Tax Court (Judge Wherry) held that the Supreme Court's opinion in *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958), "'unambiguously forecloses the [IRS] interpretation' … and displaces [the] temporary regulations." The first ground was that the temporary regulations were specifically limited their application to "taxable years with respect to which the applicable period for assessing tax did not expire before September 24, 2009," and in this case that period was not open as of that date. The second ground was that the Supreme Court had held in *Colony* that the statute was unambiguous in light of its legislative history and foreclosed temporary regulations to the contrary.

- Judges Halpern and Holmes concurred in the result. They stated that they were not persuaded by either of the majority's analyses, but that the temporary regulations should be invalidated on procedural grounds for failure to comply with the Administrative Procedure Act's notice-and-comment requirement.

n. **"Tax Court, we'll see ya at high noon in front of the courts of appeals," says the IRS.** T.D. 9511, Definition of Omission From Gross Income, 75 F.R. 78897 (12/17/10). The IRS and Treasury have finalized amendments to Regs. §§ 301.6229(c)(2)-1 and 301.6501(e)-1, replacing Temp. Reg. §§ 301.6229(c)(2)-1T and 301.6501(e)-1T, T.D. 9466, Definition of Omission from Gross Income, 74 F.R. 49321 (9/24/09). The final regulations are identical to the Temporary Regulations in providing that for purposes of determining whether there is a substantial omission of gross income, gross income as it relates to a trade or business includes the total amount received from the sale of goods or services, without reduction for the cost of goods sold, gross income otherwise has the same meaning as under § 61(a).

- The IRS and Treasury declared in the preamble that they believed that the Tax Court's decision in *Intermountain Insurance Service of Vail v. Commissioner*, 134 T.C. 211 (5/6/10), invalidating the Temporary Regulations, was erroneous:

> The Treasury Department and the Internal Revenue Service disagree with *Intermountain*. The Supreme Court stated in *Colony* that the statutory phrase ''omits from gross income'' is ambiguous, meaning that it is susceptible to more than one reasonable interpretation. The interpretation adopted by the Supreme Court in *Colony* represented that court's interpretation of the phrase but not the only permissible interpretation of it. Under the authority of *Nat'l Cable & Telecomms. Ass'n* v. *Brand X Internet Servs.,* 545 U.S. 967, 982–83 (2005), the

Back to Table of Contents

> Treasury Department and the Internal Revenue Service are permitted to adopt another reasonable interpretation of ''omits from gross income,'' particularly as it is used in a new statutory setting.

- According to the preamble, the final regulations have been clarified to emphasize that they only apply to open tax years and do not reopen closed tax years. However, the preamble states:

> The Tax Court's majority in *Intermountain* erroneously interpreted the applicability provisions of the temporary and proposed regulations, which provided that the regulations applied to taxable years with respect to which "the applicable period for assessing tax did not expire before September 24, 2009." The Internal Revenue Service will continue to adhere to the position that "the applicable period" of limitations is not the "general" three-year limitations period. ... Consistent with that position, the final regulations apply to taxable years with respect to which the six-year period for assessing tax under section 6229(c)(2) or 6501(e)(1) was open on or after September 24, 2009.

- The Supreme Court's decision in *Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 704 (1/11/11), holding that Treasury Regulations are entitled to deference under *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), will play a major role in who wins this shoot-out

o. **And Government wins in the Seventh Circuit, without any help from the Temporary Regulations.** Beard v. Commissioner, 633 F.3d 616 (7th Cir. 1/26/11), *rev'g* T.C. Memo 2009-184 (8/11/09). The Seventh Circuit, in an opinion by Judge Evans, reversed the Tax Court's decision that an overstatement of basis results in an omission of gross income that triggers the six year statute of limitations under § 6501(e)(1)(A). In a "very carefully reasoned opinion," (*but see* the *Burks* case, below) the court concluded that the Supreme Court's decision in *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958) was not controlling. The Seventh Circuit reasoned that *Colony* was both factually different – *Colony* involved an overstatement of the basis of lots held by a real estate developer for sale to customers in the ordinary course of business, while the instant case involved an overstatement of basis in a partnership interest in a Son-of-BOSS tax shelter transaction – and legally different because of changes between the 1939 Code § 275(c), which was interpreted in *Colony* and 1954 Code § 6501(e). The court held that "*Colony*'s holding is inherently qualified by the facts of the case before the Court, facts which differ from our case, where the Beards' omission was not in the course of trade or business." From the perspective of statutory interpretation, the court focused on the impact of the addition of § 6501(e)(1)(B)(ii) in the 1954 Code, which provides that "in determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item." Quoting *Phinney v. Chambers*, 392 F.2d 680 (5th Cir. 1968), the court stated "[w]e conclude that the enactment of subsection (ii) of section 6501(e)(1)[(B)] makes it apparent that the six year statute is intended to apply where there is either a complete omission of an *item* of *income* of the requisite amount or misstating of the nature of an item of income which places the "commissioner ... at a special disadvantage in detecting errors." (emphasis supplied). Even though it distinguished *Colony* and concluded that it was "left without precedential authority," the court nevertheless concluded that because the language of § 6501(e)(1)(A) at issue in the case was identical to the language of § 275(c) interpreted in *Colony*, it was required to interpret § 6501(e)(1)(A) in light of *Colony*. However, it also reasoned that it must "bear in mind" that Congress did add subsections (i) and (ii) to § 6501(e)(1)(B) and that "the section as a whole should be read as a gestalt." In analyzing Colony, the court noted that the Supreme Court had found § 275(c) to be ambiguous, but was more persuaded by the taxpayer's argument that focused on the word "omits." The Seventh Circuit noted that what *Colony* "does not address in depth is 'gross income'" which is defined generally in Section 61 of the Code as "all income from whatever source derived," but which is not defined in § 6501(e) except for the special

Back to Table of Contents

definition in § 6501(e)(1)(B)(i) that applies to trade or business income. The court then went on to hold:

> Using these definitions and applying standard rules of statutory construction to give equal weight to each term and avoid rendering parts of the language superfluous, we find that a plain reading of Section 6501(e)(1)(A) would include an inflation of basis as an omission of gross income in non-trade or business situations. ... It seems to us that an improper inflation of basis is definitively a "leav[ing] out" from "any income from whatever source derived" of a quantitative "amount" properly includible. There is an amount-the difference between the inflated and actual basis-which has been left unmentioned on the face of the tax return as a candidate for inclusion in gross income.

- The court was reinforced in its conclusion by the existence of § 6501(e)(1)(B)(i), reasoning that "[i]f the omissions from gross income contemplated Section 6501(e)(1)(A) were only specific items such as receipts and accruals, then the special definition in subsection (i) would be, if not superfluous, certainly diminished. The addition of this subsection suggests that the definition of gross income for the purposes of Section 6501(e)(1)(A) is meant to encompass more than the types of specific items contemplated by the *Colony* holding." The Seventh Circuit considered *Bakersfield Energy Partners v. Commissioner*, 568 F.3d 767 (9th Cir. 6/17/09), and *Salman Ranch Ltd. v. United States*, 573 F.3d 1362 (Fed. Cir. 7/30/09), to have been erroneously decided. Finally, the court addressed the parties' arguments regarding the impact of Temp. Reg. § 301.6501(e)-1T(a)(1)(a). Rather than ruling on the validity of the regulation, however, the court stated that because it did not find *Colony* controlling and reached its decision that the six-year statute of limitations applied on the face of the Code section, it would not reach the validity of the regulation. However, in dictum, the court stated that it would be inclined to grant deference to Temp. Reg. § 301.6501(e)-1T(a)(1)(a), even though it was issued without notice and comment, citing *Barnhart v. Walton*, 535 U.S. 212 (2002), for the proposition that "the absence of notice-and-comment procedures is not dispositive to the finding of *Chevron* deference."

p. But the Fourth Circuit relied on *Colony* to find for the taxpayer. Home Concrete & Supply, LLC v. United States, 634 F.3d 249 (4th Cir. 2/7/11), *aff'd*, 132 S. Ct. 1836 (4/25/12). The Fourth Circuit (Judge Wynn) held that *Colony* decided that 1954 Code § 6501(e)(1)(A) was unambiguous and that an overstated basis in property is not an omission from gross income that extends the limitations period. It further held that Reg. § 301.6501(e)-1(e) by its plain terms did not apply to the tax year in this case because the six-year limitations period had expired before the regulation was issued. Judge Wynn stated:

> Like the Ninth and Federal Circu*its, w*e hold that the Supreme Court in *Colony* straightforwardly construed the phrase "omits from gross income," unhinged from any dependency on the tax*payer'*s identity as a trade or business selling goods or services. There is, therefore, no ground to conclude that the holding in *Colony* is limited to cases involving a trade or business selling goods or services.
>
> Further, the Supreme Court's discussion of the legislative history behind former § 275(c) is equally compelling with regard to current § 6501(e)(1)(A). The language the Court construed in former § 275(c) "omits from gross income an amount properly includable therein"—is identical to the language at issue in § 6501(e)(1)(A). Because there has been no material change between former § 275(c) and current § 6501(e)(1)(A), and no change at all to the most pertinent language, we are not free to construe an omission from gross income as something other than a failure to report "some income receipt or accrual." …. Thus, we join the Ninth and Federal Circuits and conclude that *Colony* forecloses the argument that Home Concrete's overstated basis in its reporting of the short sale proceeds resulted in an omission from its reported gross income.

- Judge Wynn concluded that the regulation was "not entitled to deference."

q. As did the Fifth Circuit, which chided the Seventh Circuit for misinterpreting a Fifth Circuit case on which it relied in *Beard*. Burks v. United States, 633 F.3d 347 (5th Cir. 2/9/11). The Fifth Circuit (Judge DeMoss) also held that an overstatement of basis is not an omission from gross income for purposes of § 6501(e)(1)(A). Judge De Moss disagreed with the Seventh Circuit's interpretation of *Phinney v. Chambers*, 392 F.2d 680 (5th Cir. 1968), as limiting *Colony*, stating that "the Seventh Circuit failed to note the distinct factual pattern presented in *Phinney*, where the taxpayers had misstated the very nature of the item so that the IRS would not have had any reasonable way of detecting the error on the tax return. That is not the case here."

- In its final footnote, the court stated:

> Although we hold that § 6501(e)(1)(A) is unambiguous and its meaning is controlled by the Supreme Court's decision in *Colony*, we note that even if the statute was ambiguous and *Colony* was inapplicable, it is unclear whether the Regulations would be entitled to *Chevron* deference under *Mayo Foundation for Medical Research v. United States*, 131 S. Ct. 704, 711 (2011). *See, e.g., Home Concrete & Supply, LLC v. United States,*—F.3d —, No. 09-2353) 2011 WL 361495, *7 (4th Cir. Feb. 7, 2011) (declining to afford the Regulations *Chevron* deference because the statute is unambiguous as recognized by the Supreme Court in *Colony*). In *Mayo*, the Court held that the principles underlying its decision in *Chevron* "apply with full force in the tax context" and applied *Chevron* to treasury regulations issued pursuant to 26 U.S.C. § 7805(a). *Id*. at 707. Significantly, in *Mayo* the Supreme Court was not faced with a situation where, during the pendency of the suit, the treasury promulgated determinative, retroactive regulations following prior adverse judicial decisions on the identical legal issue. "Deference to what appears to be nothing more than an agency's convenient litigating position" is "entirely inappropriate." *Bowen v. Georgetown Univ. Hosp*., 488 U.S. 204, 213 (1988). The Commissioner "may not take advantage of his power to promulgate retroactive regulations during the course of a litigation for the purpose of providing himself with a defense based on the presumption of validity accorded to such regulations." *Chock Full O' Nuts Corp. v. United States*, 453 F.2d 300, 303 (2d Cir. 1971).
>
> Moreover, *Mayo* emphasized that the regulations at issue had been promulgated following notice and comment procedures, "a consideration identified . . . as a significant sign that a rule merits *Chevron* deference." 131 S. Ct. at 714. Legislative regulations are generally subject to notice and comment procedure pursuant to the Administrative Procedure Act. *See* 5 U.S.C. § 553(b)(A). Here, the government issued the Temporary Regulations without subjecting them to notice and comment procedures. This is a practice that the Treasury apparently employs regularly. *See* Kristin E. Hickman, *A Problem of Remedy: Responding to Treasury's (Lack of) Compliance with Administrative Procedure Act Rulemaking Requirements,* 76 GEO. WASH. L. REV. 1153, 1158-60 (2008) (noting that the treasury frequently issues purportedly binding temporary regulations open to notice and comment only after promulgation and often denies the applicability of the notice and comment procedure when issuing its regulations because that requirement does not apply to regulations that are not a significant regulatory action, while continuing to assert that the regulations are entitled to legislative regulation level deference before the courts). That the government allowed for notice and comment after the final Regulations were enacted is not an acceptable substitute for prepromulgation notice and comment. *See U.S. Steel Corp. v. U.S. EPA*, 595 F.2d 207, 214-15 (5th Cir. 1979).

r. Finally, a court that read *Colony* very very carefully and understands what *Colony* really said and what it really did not say. Grapevine Imports v. United States, 636 F.3d 1368 (Fed. Cir. 3/11/11), *rev'g* 77 Fed. Cl. 505 (2007). The Federal

Circuit, in a unanimous panel opinion by Judge Prost, reversed the Court of Federal Claims holding that the six-year statute of limitations does not apply to an understatement of gross income attributable to a basis overstatement. The Court of Federal Claims had relied on the Supreme Court's decision in *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958). However, the Court of Appeals for the Federal Circuit applied Reg. § 301.6229(c)(2)-1 and Reg. § 301.6501(e)-1, after first concluding that the Supreme Court's opinion in *Mayo Foundation for Medical Education and Research v. United States,* 131 S. Ct. 704 (2011), unambiguously held that a subsequently promulgated Treasury Regulation could overrule a prior judicial decision (including a Supreme Court decision), as long as the regulation was valid under the standards of *Chevron, USA, Inc. v. Natural Resources Defense Council, Inc*., 467 U.S. 837 (1984). Preliminarily the court found that the regulations, "state that *Colony* did not conclusively resolve the statutory interpretation issue, and that overstatement of basis (outside the trade or business context) can trigger the extended limitations period." A critical point in the court's reasoning was that the decision in *Colony* did not hold that the language in question, which is the language that § 6501(e)(1) has in common with § 275(c) of the 1939 Code that was at issue in *Colony*, was unambiguous.

> [The Supreme Court expressly found the predecessor statute ambiguous, and turned to the legislative history to resolve the question. ... ("[I]t cannot be said that the language [of the statute] is unambiguous."). And while it is true that the Court later referred to the updated § 6501(e)(1)(A) as "unambiguous," it did not rely or elaborate on that statement, nor was the updated statute at issue in that case. ... Further, in *Colony* the taxpayer was in the business of land sales, so § 6501(e)(1)(A)(i)'s test for income "in the case of a trade or business" expressly applied. That is not the case here. The ambiguity concerns what to do outside the trade and business context, and the only language in § 6501(e)(1)(A) applicable outside the trade or business context is the same language from the predecessor statute, "omits from gross income an amount." The Supreme Court previously noted that this term was ambiguous as to whether it encompassed an overstated basis. We therefore find *Colony* no bar to our finding that the text of the relevant statutes, standing alone, is ambiguous as to the disposition of this issue.

- Turning to *Chevron* step one analysis, the Court of Appeals concluded that §§ 6229(c)(2) and 6501(e) are ambiguous, and that the Treasury thus "is entitled to promulgate its own interpretation of these statutes, and to have that interpretation given deference by the courts so long as it is within the bounds of reason."

> [The Tax Code's use of the term "omits" suggests that the section is primarily addressed to the return where the taxpayer has "fail[ed] to include or mention" or "le[ft] out" some item rather than misrepresenting it (as by an overstatement of basis). ... But without looking beyond the text itself, we cannot say that the statute forecloses the possibility that a taxpayer's overstated basis might constitute an omission from gross income.

- Turning to the second step of the *Chevron* analysis, which asks whether the regulations constitute "a reasonable policy choice for the agency to make," the court concluded that the regulations are reasonable, even though they depart from the judicial interpretation of *Colony* and *Salman Ranch, Ltd. v. United States*, 573 F.3d 1362 (Fed. Cir. 2009). Next, the court rejected the taxpayer's arguments that the regulations were invalid were because they were "retroactive," noting that in *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180 (1957), the Supreme Court confirmed that § 7805(b) authorizes retroactive regulations. The court also rejected an argument by the taxpayer – one which we confess not to understand – that the statute of limitation expired upon the entry of judgment by the Court of Federal Claims, notwithstanding rules tolling the period of limitations during a pending appeal. Finally, based on Supreme Court precedent, the court rejected the taxpayer's claim that the Treasury did not have the power to affect the outcome of the appeal by promulgating regulations after the trial court decision and before the appeal was heard.

Back to Table of Contents

• The opinion of the Court of Appeals for the Federal Circuit does not directly address the question raised in *Home Concrete & Supply Company, LLC v. United States*, 634 F.3d 249 (4th Cir. 3/11/11) cert. granted, 132 S. Ct. 71 (9/27/11), which held that Reg. § 301.6501(e)-1(a)(1)(ii) was not applicable because according to the terms of the regulation it applies only to taxable years with respect to which the statute of limitations remained open on and after Sept. 24, 2009, and the three-year statute of limitations had expired before that date. Again, this is an argument, and a holding, that we simply cannot understand, other than as the taxpayer's and court's expression of gut feelings that it is "dirty pool" for the Commissioner to put his thumb on the regulatory scale to affect an issue pending before a court, even though in *Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 704 (1/11/11), the Supreme Court appears to have expressly blessed such a tactic, albeit in litigation over an different issue.

s. **Did anyone really expect the Tax Court to roll over and play dead just because the IRS promulgates regulations that say it wins?** Carpenter Family Investments v. Commissioner, 136 T.C. 373 (4/25/11). In a reviewed opinion by Judge Wherry, in which only four other judges joined, but with a number of concurrences and no dissents, the Tax Court once again held that the six year statute of limitations under §§ 6501(e) and 6229(c)(2) do not apply to understatements of gross income attributable to basis overstatements. In doing so the court held that final Reg. §§ 301.6501(e)-1T and 301.6229(c)(2)-1T are invalid, just as it had held in *Intermountain Insurance Service of Vail v. Commissioner*, 134 T.C. 211 (5/6/10), that Temp. Reg. §§ 301.6501(e)-1T and 301.6229(c)(2)-1T were invalid. Noting that the case was appealable to the Ninth Circuit, in which *Bakersfield Energy Partners, LP v. Commissioner*, 568 F.3d 767 (9th Cir. 6/17/09), is the controlling precedent, the Tax Court followed the line of reasoning previously applied by it, *Bakersfield Energy Partners*, and some other courts, that the Supreme Court's decision in *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958), was not limited to situations involving a trade or business and that it controlled the interpretation of § 6501(e)(1)(A). The court then turned to whether Reg. §§ 301.6501(e)-1T and 301.6229(c)(2)-1T were entitled to deference under *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), and *Mayo Foundation for Medical Research v. United States*, 131 S. Ct. 704, 711 (1/11/11), and determined that they were not entitled to deference. In this context the court observed that *Mayo* "focuses exclusively on the statutory text at *Chevron* step one and suggests (by negative implication) a disfavor of using legislative history at that stage. We are not persuaded, however, that after *Mayo*, any judicial construction that examines legislative history is automatically relegated to a *Chevron* step two holding by that fact alone." In proceeding to analyze whether under the authority of *Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.,* 545 U.S. 967 (2005), the Treasury Department and the IRS have the power to promulgate regulations overturning prior court decision, the court appears first to have concluded that "only if an 'unwise judicial construction' represents a policy choice, must it yield to 'the wisdom of the agency's policy.'" In the end, however, the court appears also to have grounded its decision on what it perceived to be ambiguities in the preamble of T.D. 9511, which promulgated the regulations at issue and which the court infers did not strongly enough invoke a power under *Brand X* as the basis for promulgating the regulations. The final passage of its reasoning as follows:

> Even if we read the Supreme Court's recent *Mayo* opinion as a license to categorize most judicial constructions that discuss legislative history as *Chevron* step two decisions, respondent has yet to unabashedly accept the Court of Appeals for the Ninth Circuit's invitation and issue regulations that unequivocally repudiate the *Colony* holding. Unless and until he does so, his hands must remain tied.

• Judge Thornton's concurring opinion, with which Judges Cohen, Halpern, Holmes, and Paris agreed, would have decided the case solely on the grounds that the result "follows from the unambiguous terms of the statute," and there is no compelling reason for the Tax Court to abandon its precedents.

• Judges Halpern and Holmes joined in another concurring opinion discussing the scope and meaning of *Chevron* and *Brand X*.

t. And the Tenth Circuit also likes the way the IRS thinks. Salman Ranch, Ltd. v. Commissioner, 647 F.3d 929 (10th Cir. 5/31/11). In a case involving a different tax year for the taxpayer, the Federal Circuit held, see e. and f., above, that the extended statute of limitations did not apply to this partnership for its 1999 year. Subsequently, in *Grapevine Imports v. United States*, 636 F.3d 1368 (Fed. Cir. 3/11/11), see r., above, the Federal Circuit overruled its pro-partnership decision in the 1999 *Salman Ranch* case. In this separate case for this partnership's 2001 and 2002 years, the Tax Court had held collateral estoppel required summary judgment be granted for the partnership. The Tenth Circuit (Judge Seymour) reversed and remanded, holding that collateral estoppel was inapplicable because of an intervening change in law, i.e., the final regulations (see n., above). Judge Seymour based his decision that the final regulations were entitled to *Chevron* deference based upon the Supreme Court's holdings in *Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 713 (1/11/11), and refused to follow contrary authority among the cases discussed above.

u. And the government chalks up another victory in front of a panel that really understands the proposition for which *Colony* stands and the propositions for which it really does not stand. Intermountain Insurance Service of Vail v. Commissioner, 650 F.3d 691 (D.C. Cir. 6/21/11). After a thorough examination of the history of § 275(c) of the 1939 Code, the pre-*Colony* litigation, the *Colony* decision itself, the enactment of § 6501(e) and the relevant changes from § 275(c), and the recent cases on the issue, and the promulgation of Reg. §§ 301.6501(e)-1T(a)(iii) and 301.6229(c)(-1T)(a)(iii), the Court of Appeals for the District of Columbia, in an opinion by Judge Tatel, reversed the Tax Court and, with a healthy spread of *Mayo*, upheld the regulations, and dismissed the taxpayer's [tautological, in our opinion] argument, which was accepted by the Tax Court (and a few other courts) that the regulations by the terms of their effective date were inapplicable to the transaction in question. The court's opinion carefully explains the source of the statutory ambiguity and why *Colony* did not state that the relevant language was unambiguous, rejecting the less well reasoned opinions of those courts that found *Colony* to have held that the statutory provision was unambiguous. Going a step further, the court concluded that *Colony* simply did not apply to either § 6501(e) or § 6229(c)(2), and that under *Chevron* it was an easy call to uphold the substance of the regulations, while under *Mayo* there were no procedural problems with the manner in which the regulations were promulgated. However, the Court of Appeals remanded the case to the Tax Court to consider Intermountain's alternative argument that Intermountain avoided triggering the extended statute of limitations by "adequately disclos[ing] to the IRS the basis amount it applied in connection with the transaction at issue."

v. Let's play that tune again. UTAM, Ltd v. Commissioner, 645 F.3d 415 (D.C. Cir. 6/21/11). The Court of Appeals for the District of Columbia, in a very brief opinion by Judge Randolph, reversed the Tax Court decision (see l., above) on the basis of the court's holding in Intermountain Insurance Service of Vail v. Commissioner, 650 F.3d 691 (D.C. Cir. 6/21/11). Although the Tax Court did not reach the issue of whether § 6229(c) suspends the individual partner's § 6501 limitations period when that period is open on the date the IRS mailed the FPAA, the Court of Appeals found that a remand on this issue would not serve a useful purpose. Under D.C. Circuit's opinion in *Andantech, L.L.C. v. Commissioner*, 331 F.3d 972 (D.C. Cir. 2003), the assessment period suspended by § 6229(d) is the partner's open assessment period under § 6501. Thus, the statute of limitations had not run.

w. The Fifth Circuit stands by its *Burks* holding, and the government is ready to talk to the Supreme Court. R and J Partners v. Commissioner, 441 Fed. Appx. 271 (5th Cir. 9/19/11). In a per curiam opinion the Fifth Circuit followed *Burks v. United States*, 633 F.3d 347 (5th Cir. 2011), to hold that the six year statute of limitations of § 6501(e) does not apply to basis overstatements and that Reg. § 301.6501(e)-1 is invalid.

- The court noted that "The Commissioner agrees that *Burks* controls the law in the circuit on that question and that the Tax Court correctly applied that law, but took this protective appeal in an effort to obtain a review by the Supreme Court." However, the Supreme Court did not grant certiorari in this case.

x. **And now the Supremes will sing †♫♪ "Nothing But Heartaches" ♫♪! But will the song be dedicated to the taxpayer or the government?** The Supreme Court granted certiorari to the Fourth Circuit in *Home Concrete & Supply, LLC v. United States*, 634 F.3d 249 (4th Cir. 2/7/11), *cert. granted*, 132 S. Ct. 71 (9/27/11). It declined invitations from the government to consider cases from the Fifth and Seventh Circuits.

y. **Taxpayer wins in the Supreme Court, 5-4.** United States v. Home Concrete and Supply, LLC, 132 S. Ct. 1836 (4/25/12). In an opinion by Justice Breyer, a former law professor in the administrative law area, the Supreme Court held that there is no extension of the three-year statute of limitations under § 6501(e)(1)(A) "when the taxpayer *overstates his basis* in the property that he has sold, thereby *understating the gain* that he received from its sale." (emphasis in original) Justice Breyer rests this conclusion on the precedential value of *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958), which construed identical operative language and concluded that the statute's scope is limited "to situations in which specific receipts or accruals of income are left out of the computation of gross income," and that the word "omits" (unlike, say, "reduces" or "understates") means "'[t]o leave out or unmentioned; not to insert, include, or name.'" He rebuts the government argument that because the *Colony* opinion stated "it cannot be said that the language is unambiguous," there is room for a regulation that is a "permissible construction," stating:

> We do not accept this argument. In our view, *Colony* has already interpreted the statute, and there is no longer any different construction that is consistent with *Colony* and available for adoption by the agency.

- The test stated in the plurality opinion – Justice Scalia did not join the Court's opinion on this point – was whether Congress delegated "gap-filling authority" to the agency. Justice Breyer's opinion stated that the *Colony* opinion, including its examination of the legislative history to the statute, concluded that Congress "had decided the question definitely, leaving no room for the agency to reach a contrary result.

- Justice Scalia's concurring opinion would have overruled the *National Cable & Telecommunications Assn. v. Brand X Internet Services*, 545 U.S. 967 (2005), holding that "a 'prior judicial construction,' unless reflecting an 'unambiguous' statute, does not trump a different agency construction of that statute."

- Four justices dissented in an opinion by Justice Kennedy on the ground that the 1954 Code amendments to the statute created inferences that would have permitted the Treasury to promulgate its contrary regulations. Justice Breyer dismissed this position in part by stating that to rely on one of these changes "is like hoping that a new batboy will change the outcome of the World Series."

- **Has the Court cut the hair of *Brand X* and *Mayo*?** In invalidating the regulations, the Court held that a regulation can validly trump a prior judicial interpretation of a statute only if the "statute's silence or ambiguity as to a particular issue means that Congress has not 'directly addressed the precise question at issue' (thus likely delegating gap-filling power to the agency)." The Court noted that in *Chevron* it stated that "'[i]f a court, employing traditional tools of statutory construction, ascertains that Congress had an intention on the precise question at issue, that intention is the law and must be given effect.'" This logic is somewhat tautological, because it presumes that it is for agencies, through regulations, not courts, through judicial decisions, to fill gaps in the statute, but then states that if a court has already interpreted the statute in the absence of a regulation, that the court, per force, has ascertained congressional intent and there is no gap in the statute remaining to be filled to filled by regulations. Moreover, the Court's opinion is ambiguous with respect to which court's prior decision cannot be overturned by regulations — does this principle apply only to Supreme Court decisions to lower court, for example, Tax Court, decisions as well? Even more troubling is how this principle applies to splits between lower courts, for example, if the IRS prevails in the Tax Court but the decision is reversed on appeal, what are the limits on the Treasury Department's power to enshrine its Tax Court victory in Regulations.

Back to Table of Contents

2. Tolling is personal; it can't be inherited. Murdock v. United States, 109 A.F.T.R.2d 2012-892 (Fed. Cl. 2/9/12). The trustee of a deceased taxpayer's trust filed tax returns for the deceased taxpayer for the years 2001-2006, for which the taxpayer, who had died on May 4, 2006, had not filed returns. The trustee did not discover that no returns had been filed until January 2009, and did not file the returns until September 2009. Taxes had been withheld by the government on pension payments. In an attempt to avoid the limitations of § 6511(b)(2), the trustee argued that the tolling of the period of limitations on refunds under § 6511 applied, because the taxpayer's failure to file returns was "attributable to his advanced age, medical ailments, and alcoholism." The court (Judge Lettow) rejected the trustee's claim, holding that § 6511(h) tolls the period of limitations only during the taxpayer's lifetime; "if the financially disabled taxpayer is no longer alive, Subsection 6511(h) can no longer apply and the statutory clock must begin to run." Thus, the three year look-back period had expired in May 2009.

F. Liens and Collections

1. The taxpayer won on the evidentiary issue, but that was all. Kreit Mechanical Associates, Inc. v. Commissioner, 137 T.C. 123 (10/3/11). The taxpayer sought review of the IRS's CDP determination following the rejection of the taxpayer's offer in compromise. The IRS's determination was based on its conclusion that the entire amount due was collectible after it found that a 75-percent discount of taxpayer's accounts receivable was inappropriate in valuing its assets. Applying the *Golsen* rule (*Golsen v. Commissioner*, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971), following Ninth Circuit precedent (*Keller v. Commissioner*, 568 F.3d 710, 718 (9th Cir. 2009), the Tax Court (Judge Wherry) limited the review of the administrative determination to the administrative record. However, under an exception to the administrative record rule in the Ninth Circuit by which "[t]he extra-record inquiry is limited to determining whether the agency has considered all relevant factors and has explained its decision," *Friends of the Payette v. Horseshoe Bend Hydroelectric Co.*, 988 F.2d 989, 997 (9th Cir. 1993), as a preliminary matter, Judge Wherry allowed into evidence, over the IRS's objection, a report by an expert witness (a former IRS revenue officer and settlement officer, with over thirty years of experience) for the taxpayer that "opine[d] on other factors that [the expert witness] believed the settlement officer should have taken into account when evaluating [taxpayer's] offer-in-compromise and ability to make payments," because "the report is helpful to the Court in understanding respondent's administrative procedures and options and assists the Court in comprehending the evidence." Having done so, the court quickly concluded that the IRS had not abused its discretion.

2. Ya gotta tell the court ya want a speedy trial. Thompson v. United States, 106 A.F.T.R.2d 2010-6464 (N.D. Ill. 9/29/10). The failure of the district court to review a jeopardy assessment within twenty days, as required by § 7429(b)(2) is not alone grounds for entering judgment for the taxpayer. The taxpayer bears the responsibility for informing the district court of the statutory time deadline. The taxpayer failed to do so.

a. The Seventh Circuit echoes the District Court: Ya gotta tell the court ya want a speedy trial. Thompson v. United States, 448 Fed. Appx. 878 (7th Cir. 11/3/11), *aff'g* 106 A.F.T.R.2d 2010-6464 (N.D. Ill. 9/29/10). The failure of the district court to review a jeopardy assessment within twenty days, as required by § 7429(b)(2) is not alone grounds for entering judgment for the taxpayer. The twenty-day provision is "'only a strong admonition for the judiciary to act expeditiously' rather than 'a limitation on the lower courts' jurisdiction....'"; the levy should not be voiding unless the plaintiff has shown extraordinary diligence in informing the court that the case is ready for a prompt ruling. The taxpayer bears the responsibility for informing the district court of the statutory time deadline. The taxpayer failed to do so.

3. IRS mails wrong form, but provides required information. Just as in the NBA, no harm, no foul. Conway v. Commissioner, 137 T.C. No. 16 (12/19/11). If the IRS fails to comply with the requirement of § 6303(a) that within sixty days of the assessment it notify the taxpayer and demand payment, the IRS may be barred from collecting through nonjudicial procedures. In this CDP case involving trust fund taxes owed by a failed airline, the

Back to Table of Contents

Tax Court (Judge Paris) followed *Hughes v. United States*, 953 F.2d 531 (9th Cir. 1992), holding that the form on which a notice of assessment and demand for payment is made is irrelevant as long as it provides the taxpayer with all of the information required by § 6303. In the case at bar, with respect to one taxpayer [the failed airline's CFO] a levy notice constituted adequate notice under § 6303 because it went beyond the typical notice of intent to levy by including a demand for immediate payment of the specific amounts of the taxes owed, listed by period, within sixty days of the assessment, even though no earlier adequate notice had been provided.

- However, with respect to another taxpayer [the failed airline's CEO], a lien notice that merely reflected that unpaid taxes were owed, but which did not state the amounts, types, or periods of the unpaid taxes, was not adequate notice under § 6303(a). The court rejected the IRS's argument that the taxpayer's multiple communications with IRS Appeals before the assessments regarding the amounts of the unpaid taxes had provided him with constructive notice.

4. **Bankruptcy doesn't prevent the IRS from collecting tax shelter based deficiencies.** In re Vaughn, 463 B.R. 531 (Bankr. Colo. 12/28/11). The taxpayer's tax debts arising from disallowed "BLIPS" tax shelter losses were excepted from discharge under the 11 U.S.C. § 523(a)(1)(C) fraudulent return and/or willful evasion provisions. Fraudulent return evidence included facts that despite taxpayer's business experience and savvy, he disregarded numerous red flags about the BLIPS transaction, relied on the promoter's advice, and entered into the transaction without obtaining a truly independent opinion as to its potential and its tax implications.

5. **You can't tell the filing period deadline without a scorecard.** Gray v. Commissioner, 138 T.C. No. 13 (3/28/12). The Tax Court (Judge Gale) followed *Raymond v. Commissioner*, 119 T.C. 191 (2002), holding that where a taxpayer raises § 6015 relief in a § 6330 CDP hearing, and the notice of determination included a determination that the taxpayer was not entitled to § 6015 relief a Tax Court petition, filed more than 30 days, but within 90 day, after the issuance of the notice of determination, was timely for purposes of conferring jurisdiction on the Tax Court to determine the appropriate § 6015 relief. However, *Barnes v. Commissioner*, 130 T.C. 248 (2008), held that a second request for § 6015(f) relief from an underpayment that was essentially duplicative of an earlier request for which a final determination had been issued did not confer jurisdiction on the Tax Court under § 6015(e)(1)(A). On the basis of the record developed in this case, the court was unable to determine whether the claim for § 6015 relief that the taxpayer raised at her CDP hearing is "sufficiently dissimilar" from the claim for which she received an earlier final determination, and further proceedings were necessary to determine whether jurisdiction exists. On a second issue, the court held that the petition was timely for purposes of conferring jurisdiction under § 6404(h)(1) to determine whether the IRS's determination not to abate interest, which was requested by the taxpayer in the CDP hearing was an abuse of discretion. The notice and petition conferred jurisdiction under § 6404(h) that was independent of § 6330. Insofar as the petition sought review under § 6404(h) of the IRS's failure to abate interest, it was timely because it was filed within 180 days of the final determination not to abate interest.

6. **Ca-ching! The IRS collects twice.** Weber v. Commissioner, 138 T.C. No. 18 (5/7/12). In 2007 the taxpayer filed an income tax return for 2006 reporting an overpayment and elected to have it applied to his 2007 estimated income tax. However, the IRS had determined that the taxpayer was liable for a § 6672 penalty and instead applied the income tax overpayment to that penalty liability. In 2008 the trust fund tax liability was satisfied by third-party payments, and when thereafter the taxpayer filed his 2007 income tax return, he claimed a credit for the overpaid 2006 income tax, thereby reporting a 2007 income tax overpayment, and elected to have that asserted 2007 overpayment applied to his 2008 estimated income tax. The IRS adjusted the 2007 credits downward to eliminate the claimed 2006 income tax overpayment, thereby eliminating the overpayment for 2007, resulting in a balance due. This pattern was repeated in when the taxpayer filed his 2008 income tax return in 2009, when he again claimed a credit for earlier overpaid income tax. When the taxpayer did not did not pay the balance due, the IRS issued a notice of proposed levy, and the taxpayer requested a CDP hearing. At the CDP

hearing the taxpayer argued that the § 6672 penalty had been overpaid and that his income tax liability would be satisfied if that overpayment were applied to his income tax liability. The IRS rejected his argument and determined to proceed with the levy. The Tax Court (Judge Gustafson) held that the taxpayer was not entitled to apply the earlier income tax overpayment to his later income tax liability, because after application of the income tax overpayment to the § 6672 penalty liability, there was 2006 overpayment available. Furthermore, in reviewing the CDP hearing, the Tax Court lacked jurisdiction to adjudicate the taxpayer's claim of a § 6672 penalty overpayment. Section 6330 – the statute conferring CDP jurisdiction on the Tax Court – has no provisions conferring and delimiting any overpayment jurisdiction. Finally, the opinion described the many administrative problems that would arise from allowing a person against whom a § 6672 penalty had been assessed and collected to seek a credit (or refund) based on the assertion that the penalty had been "over-collected."

7. **The whole is greater than the sum of the parts.** Lewis v. Commissioner, T.C. Memo. 2012-138 (5/16/12). In this review of an IRS CDP determination to proceed with a levy, Judge Paris held that the IRS had abused its discretion. "While each individual defect on its own may be insufficient to support a holding that [the IRS] abused [its] discretion, the cumulative effect of such defects demonstrates that [the IRS] acted both arbitrarily and capriciously in rendering [its] determination." The IRS's argument sought "to quilt together a string of exceptions to account for [the] deviation from what one would consider a thorough review of [the taxpayer's] case. Accordingly, the IRS abused his discretion in sustaining the proposed levy.

G. Innocent Spouse

1. **The IRS is attempting to be more equitable in granting innocent spouse relief.** Notice 2012-8, 2012-4 I.R.B. 309 (1/6/12). This notice provides a proposed revenue procedure that will supersede Rev. Proc. 2003-61, 2003-2 C.B. 296, which provides guidance regarding § 6015(f) relief from joint and several liability. The factors used in making § 6015(f) innocent spouse relief determinations will be revised "to ensure that requests for innocent spouse relief are granted under section 6015(f) when the facts and circumstances warrant and that, when appropriate, requests are granted in the initial stage of the administrative process." The revenue procedure expands how the IRS will take into account abuse and financial control by the nonrequesting spouse in determining whether equitable relief is warranted, because when a requesting spouse has been abused by the nonrequesting spouse, the requesting spouse may not have been able to challenge the treatment of any items on the joint return, question the payment of the taxes reported as due on the joint return, or challenge the nonrequesting spouse's assurance regarding the payment of the taxes. Furthermore, a lack of financial control may have a similar impact on the requesting spouse's ability to satisfy joint tax liabilities. Thus, the proposed revenue procedure provides that abuse or lack of financial control may mitigate other factors that might otherwise weigh against granting § 6015(f) equitable relief. The proposed revenue procedure also provides for certain streamlined case determinations; new guidance on the potential impact of economic hardship; and the weight to be accorded to certain factual circumstances in determining equitable relief.

- Until the revenue procedure is finalized, the IRS will apply the provisions in the proposed revenue procedure instead of Rev. Proc. 2003-61 in evaluating claims for equitable relief. But if a taxpayer would receive more favorable treatment under one or more of the factors provided in Rev. Proc. 2003-61 and so advises the IRS, the IRS will apply those factors from Rev. Proc. 2003-61, until the new revenue procedure is finalized.

a. **The Tax Court tells the IRS that even if it wants to make a taxpayer favorable change to a Revenue Procedure, it needs to finalize it, not just publish a proposed Revenue Procedure.** Deihl v. Commissioner, T.C. Memo. 2012-176 (6/21/12). The Tax Court (Judge Marvel) declined to apply the provisions of the proposed revenue procedure set forth in Notice 2012-8, 2012-4 I.R.B. 309, in determining whether the taxpayer was entitled to equitable relief under § 6015(f) and instead applied Rev. Proc. 2003-61, 2003-2 C.B. 296, "in view of the fact that the proposed revenue procedure is not final and because the comment period under the notice only recently closed." It did however note "where appropriate how the analysis used in Rev. Proc. 2003-61 ... would change if the proposed revenue procedure in Notice 2012-8 ... had actually been finalized." But on the facts the proposed changes did not affect the conclusion that relief was not warranted.

2. **The Tax Court strikes a blow for greater employment opportunities for tax lawyers.** Harbin v. Commissioner, 137 T.C. 93 (9/26/11). The taxpayer sought § 6015(b) relief for taxes attributable to his former wife's gambling activities. The amount of the liability had been determined in a prior proceeding in which the issue of § 6015 relief had not been raised by the attorney who had jointly represented both spouses in both the tax proceeding and their contemporaneous divorce. Section 6015(g)(2) bars a spouse who has meaningfully participated in a court proceeding involving the taxable year in issue from subsequently electing innocent spouse relief under § 6015(b) or apportioned liability under § 6015(c). Judge Kroupa held that § 6015(b) did not bar the taxpayer from seeking § 6015(b) relief because, due to his attorney's conflict of interest in the prior proceeding, the taxpayer had not materially participated in the earlier proceeding. The taxpayer's and his wife's "financial interests and interests in the allocation of liability for the deficiencies at issue were adverse in the prior deficiency case [and the attorney's] joint representation ... in the prior deficiency case created a conflict of interest." The taxpayer's wife had exercised control over the prior proceeding and all communication between the IRS and the taxpayer and his wife had been through the attorney. The attorney had not explained the conflict or sought a waiver. Nor had the attorney informed the taxpayer of the opportunity to seek § 6015 relief. The taxpayer had a "viable claim" for § 6015 relief, but the opportunity to raise that claim "was obscured and obstructed" by the attorney's joint representation. After holding that the bar of § 6015(g)(2) did not apply, Judge Kroupa went on to grant § 6015(b) relief on the facts, because the IRS had stipulated that § 6015(b) relief was warranted if the § 6015(g)(2) bar did not apply.

3. **An IRS levy on a joint account doesn't trump a spouse's right to seek § 6015(g) relief.** Minihan v. Commissioner, 138 T.C. No. 1 (1/11/12). At the time the taxpayer was seeking Tax Court review of the IRS's denial of § 6015(g) relief, the IRS levied on a joint bank account owned by the taxpayer's husband and the taxpayer to satisfy the tax liability. At that time collection against the taxpayer was suspended pursuant to § 6015(e)(1)(B). Judge Gustafson held that because under state law the taxpayer owned one-half of the funds in the bank account, she was not precluded from seeking a refund of one-half of the funds in the account if she prevailed on the § 6015(f) relief issue. While a taxpayer who is relieved from joint and several liability under § 6015(f) in a Tax Court proceeding is not entitled to a refund under § 6015(g)(1), unless the taxpayer made an overpayment, if the taxpayer prevailed, the levy on her one-half of the bank account funds would constitute an overpayment as defined in § 6402(a). Although *United States v. Nat'l Bank of Commerce*, 472 U.S. 713 (1985), held that the IRS can lawfully levy on a joint bank account to satisfy one account holder's individual tax liability, that levy is conditional, and it does not extinguish a third party's rights in levied property. The court then concluded that the rights of an "innocent spouse" who claims a refund under § 6015(g)(1) survive post-levy in the same way that the rights of a § 7426 or § 6343(b) wrongful levy claimant survive. Accordingly, the IRS was denied summary judgment, and whether Mrs. Minihan deserved § 6015(f) relief was a matter for trial.

H. Miscellaneous

1. **IRS releases recommendations that paid tax return preparers would be required to register.** IR-2010-1, 2010 TNT 2-1 (1/4/10). The IRS released a list of recommendations that would require that individuals who sign a tax return as a paid preparer pay a user fee to register online with the IRS and obtain a preparer tax identification number [PTIN]. All preparers – except attorneys, CPAs and enrolled agents – would have to pass competency exams and complete 15 hours of annual CPE in federal tax law topics. The IRS proposes to expand Circular 230 to cover all signing and nonsigning return preparers. Registered preparers would be listed on a publicly-searchable data base and would be required to have PTINs in 2011.

Back to Table of Contents

a. **It is only a rumor that the IRS Return Preparer Office has put out an RFP for DNA matching services.** REG-116284-11, User Fees Relating to the Registered Tax Return Preparer Competency Examination and Fingerprinting Participants in the Preparer Tax Identification Number, Acceptance Agent, and Authorized E-File Provider Programs, 76 F.R. 59329 (9/26/11). These proposed regulations would set fees going to the IRS of (1) $27 for taking the registered tax return preparer competency examination testing and (2) $33 for being fingerprinted. These fees are in addition to the unspecified fees that will be paid to the private vendors that administer the examinations and take fingerprints.

b. Notice 2011-80, 2011-43 I.R.B. 591 (9/21/11). This notice provides guidance for the issuance of provisional PTINs and their annual renewal on a calendar year basis. It also states that the IRS will not require individuals to be fingerprinted prior to obtaining a PTIN until at least 4/18/12. Attorneys, CPAs, enrolled agents, enrolled retirement plan agents and enrolled actuaries will not be required to be fingerprinted "at this time."

c. **Proposed return preparer penalty regulations.** REG-140280-09, Tax Return Preparer Penalties Under Section 6695, 76 F.R. 62689 (10/11/11). Proposed regulations under § 6695(g), Prop. Reg. § 1.6695-2, relating to tax return preparer due diligence requirements for determining under earned income credit eligibility. When made final, the regulations will require the completion and submission of Form 8867 with each tax return or claim for refund claiming the EIC.

d. **New return preparer penalty regulations are finalized in the blink of an eye.** T.D. 9570, Tax Return Preparer Penalties Under Section 6695, 76 F.R. 78816 (12/20/11). The proposed regulations have been finalized substantially as proposed, with a few changes. Reg. § 1.6695-2(b)(1)(i) provides that tax return preparers who prepare a tax return or claim for refund but do not submit it directly to the IRS may satisfy their due diligence obligation regarding submission of Form 8867 by providing the form to the taxpayer or the signing tax return preparer, as appropriate, for submission with the tax return or claim for refund claiming the earned income credit. Individuals employed at the tax preparation software companies generally are not nonsigning tax return preparers as long as they either (1) fall within a mechanical exception because they are not exercising independent judgment on the taxpayer's underlying tax positions, or (2) do not know (and reasonably should not know) that any generic advice provided relating to the EIC is a substantial portion of the tax required to be shown. The record retention date under the final regulations will be the same for nonsigning tax return preparers supervised by a signing tax return preparer in the same firm and nonsigning tax return preparers who are employed by a different firm than that of the signing tax return preparer; in both cases, the records must be retained until three years from the later of the due date of the tax return or the date the tax return or claim for refund is submitted in final form to the signing tax return preparer.

2. **The whistleblower made no noise, and keeps his (?) identity secret .** Whistleblower 14106-10W v. Commissioner, 137 T.C. No. 15 (12/9/11). In a reviewed opinion by Judge Thornton, the Tax Court granted summary judgment for the IRS in this case in which a whistleblower appealed the IRS's denial of a reward. The IRS filed the affidavit of a Chief Counsel Attorney "declaring, on the basis of his review of respondent's administrative and legal files and on the basis of conversations with relevant IRS personnel, that the information petitioner provided resulted in respondent's taking no administrative or judicial action against X or collecting from X any amounts of tax, interest, or penalty," and the whistleblower did "not set forth, by affidavits or otherwise, any specific facts showing that there [was] a genuine issue for trial." The court granted the whistleblower's request for anonymity and redaction from the record of any identifying information because the potential harm from disclosing the whistleblower's identity as a confidential informant outweighed the public interest in knowing the whistleblower's identity in a case decided on summary judgment for the IRS denying an award. Because granting the request for anonymity and redaction adequately protected the whistleblower's privacy interests as a confidential informant, the motion to seal the record was denied.

a. Calculating collected proceeds in calculating whistleblower awards. T.D. 9580, Rewards and Awards for Information Relating to Violations of Internal Revenue Laws, 77 F.R. 10370 (2/22/12). The Treasury Department promulgated final regulations relating to the payment of rewards under § 7623(a) for detecting underpayments or violations of the internal revenue laws and whistleblower awards under § 7623(b) that amend Reg. § 301.7623-1. The amendments clarify the definitions of proceeds of amounts collected and collected proceeds and provide that the provisions of Reg. § 301.7623-1(a) concerning refund prevention claims are applicable to claims under § 7623(a) and (b). "[B]oth proceeds of amounts collected and collected proceeds include: Tax, penalties, interest, additions to tax, and additional amounts collected by reason of the information provided; amounts collected prior to receipt of the information if the information provided results in the denial of a claim for refund that otherwise would have been paid; and a reduction of an overpayment credit balance used to satisfy a tax liability incurred because of the information provided."

b. You could be the next one to strike it rich by ratting out your employer. IRS Summary Award Report, 9/11/12. The IRS Whistleblower Office recommended a payment of $104 million to former UBS banker Bradley Birkenfeld based on his 2009 claim under § 7623(b). The non-redacted portion of the recommendation read:

> Birkenfeld provided information on taxpayer behavior that the IRS had been unable to detect, provided exceptional cooperation, identified connections between parties to transactions (and the methods used by UBS AG), and the information led to substantial changes in UBS AG business practices and commitment to future compliance. The actions against UBS AG and the attendant publicity also contributed to other compliance programs. Each of these factors could support an increase in the award percentage above the statutory minimum. The comprehensive information provided by the whistleblower was exceptional in both its breadth and depth. While the IRS was aware of tax compliance issues related to secret bank accounts in Switzerland and elsewhere, the information provided by the whistleblower formed the basis for unprecedented actions against UBS AG, with collateral impact on other enforcement activities and a continuing impact on future compliance by UBS AG.

3. Even if they thought God was on their side, the AIA still kept them out of Paradise. Christian Coalition of Florida, Inc. v. United States, 662 F.3d 1182 (11th Cir. 11/15/11). The Eleventh Circuit held that the § 7421 Anti-Injunction Act barred further proceedings in a case originally filed as a refund suit by an organization claiming tax exemption under § 501(c)(4). After the suit had been filed the IRS refunded the taxes in full because the statute of limitations on collection had run before the taxes had been assessed. The District Court granted the government's motion to dismiss the suit as moot. Section 7428 authorizes declaratory judgment actions only for organizations seeking exemption under § 501(c)(3). Thus, the plaintiff's suit was barred by the AIA.

4. New Tax Court proposed rules (12/28/11). In December of 2011, the United States Tax Court proposed amendments to its Rules of Practice and Procedure. Comments in writing were due by 2/27/12. The proposals include:

(1) amending Rule 23 to: (a) reduce the number of copies required for papers filed with the Court, (b) delete the nonproportional font requirement for papers filed with the Court, and (c) revise the language regarding the Court's return of documents;

(2) deleting Rule 175, as the number of copies required for papers filed with the Court in small tax cases would be the same as in all other cases;

(3) amending Rule 26 to require electronic filing by most attorneys;

(4) amending Rules 70 and 143 to conform the Court's Rules to rule 26(a)(2)(B) of the Federal Rules of Civil Procedure, regarding the contents of expert witness reports, rule 26(b)(3) of the Federal Rules of Civil Procedure, regarding work product protections, and revisions to rule 26(b)(4) of the Federal Rules of Civil Procedure, limiting discovery of draft expert witness reports and trial preparation communications and materials;

Back to Table of Contents

(5) amending Rule 121, Summary Judgment, to conform the Rule with revisions to rule 56 of the Federal Rules of Civil Procedure;

(6) amending Rule 155 to clarify that computations may be filed in conjunction with dispositive orders;

(7) amending Rule 241, Commencement of Partnership Actions, so that its notice provisions are consistent with those of Reg. § 301.6223(g)-1(b)(3);

(8) adopting new Rule 345 to provide privacy protections in whistleblower cases;

(9) amending various Rules to make conforming changes; and

(10) providing new Form 18 in recognition of 28 U.S.C. sec. 1746, which allows an unsworn declaration to substitute for an affidavit.

a. The proposed rules were adopted effective 7/6/12.

5. Just because the case was an S case doesn't entitle the taxpayer to a mulligan. Or, in other words, if you don't want an adverse decision in an S case, which would be res judicata, hire John W. Davis to represent you in the S case. Koprowski v. Commissioner, 138 T.C. No. 5 (2/6/12). In a reviewed decision by Judge Gustafson, the Tax Court held (with no dissents) that res judicata attaches to final decisions in a small tax case and bars relitigation of a liability determined in such a case. In this case the taxpayer was not allowed to relitigate a clam for innocent spouse relief that could have been raised in earlier small case regarding the deficiency.

- In a concurring opinion, Judge Holmes noted that "the same result will certainly follow when the Tax Court finally addresses the question of whether decisions in S cases collaterally estop losing parties from relitigating the same issues in later cases."

6. Updating the "independence" of Appeals. Rev. Proc. 2012-18, 2012-10 I.R.B. 455 (2/15/12). This revenue procedure provides comprehensive guidance in narrative format regarding *ex parte* communications between Appeals and other IRS functions. Rev. Proc. 2000-43, 200-2 C.B. 404 was amplified, modified and superseded.

7. IRS provides "Fresh Start" penalty relief for the faltering self-employed and the unemployed. IR-2012-31 (3/7/12). Relief for the failure-to-pay penalty of 0.5 percent per month (up to a maximum of 25 percent) is provided for otherwise compliant taxpayers who are either wage earners who have been unemployed for at least 30 days during 2011 and 2012 (up to the 4/17/12 filing deadline) or self-employed people who experienced a 25 percent or greater reduction in business income due to the economy. The announcement also doubles the dollar threshold for tax balance due amount that qualify for the streamlined installment agreement program from $25,000 to $50,000 and raises the term for such agreements from five years to six years; these programs can be set up on the IRS website without the filing of Form 433-A or Form 433-F financial statements.

a. The IRS announces more flexible offer-in-compromise terms. IR-2012-53 (5/21/12). The IRS announced an expansion of its "Fresh Start" initiative that would enable taxpayers to revise their tax problems in as little as two years (compared to the four or five years in the past). The changes include: (1) revising the calculation for the taxpayer's future income; (2) allowing taxpayers to repay their student loans; (3) allowing taxpayers to pay state and local delinquent taxes; and (4) expanding the Allowable Living Expense allowance category and amount.

8. No evidence of this, no evidence of that, no memory of anything — how in the world did this taxpayer expect to prove that it actually had filed a refund claim? Maine Medical Center v. United States, 675 F.3d 110 (1st Cir. 3/30/12). The issue in this case was whether an administrative refund claim had been timely filed. No one could locate a certified mail receipt or return receipt. No agent of the taxpayer had a specific memory of mailing the claim, and no one was aware of the identity of the postal service employee who would have dealt with the mailing of the claim. The IRS asserted that it has no record of ever receiving the claim. The First Circuit (Judge Stahl) held that Reg. § 301.7502-1(e), promulgated in 2011 forecloses the use of extrinsic evidence – not that there really could have been any such evidence after all of the things about which there was no evidence had been ascertained – as a means of proving a timely postmark. Thus there was no jurisdiction to hear a refund suit. The court acknowledged that in cases decided before the promulgation of Reg. § 301.7502-1(e), see *Anderson v. United States*, 966 F.2d 487 (9th Cir. 1992); Estate of *Wood v. Commissioner*, 909 F.2d. 1155 (8th Cir. 1990), other circuits had held that a taxpayer was entitled to prove via extrinsic evidence that its refund claim had a timely postmark, but described the holding in those cases as limited to the holding in those case was limited to allowing the extrinsic evidence to give rise to the common law presumption of delivery in a § 7502 context and were thus not applicable because there was no evidence that the IRS ever received the refund claim.

9. A zero return is a nothing. Waltner v. United States, 679 F.3d 1329 (Fed. Cir. 4/19/12). The Federal Circuit (Judge Prost) held that amended returns showing zeros for all income items and income taxes withheld were not a valid tax returns, and hence not valid administrative refund claims. Thus there was no jurisdiction to hear a refund suit.

10. The Constitution does not require Appeals Officers for CDP hearings to be appointed by the President. Tucker v. Commissioner, 109 A.F.T.R.2d 2012-1861 4/20/12), *aff'g* 135 T.C. 114 (7/26/10). The taxpayer requested a CDP hearing after the IRS issued a notice of filing of a tax lien. After the settlement officer had upheld the tax lien notice, the taxpayer requested a remand for a hearing to be heard by an officer appointed by the President or the Secretary of the Treasury, in compliance with the Appointments Clause of U.S. Const., art. II, sec. 2, cl. 2. The Tax Court (Judge Gustafson) held that an "officer or employee" or an "appeals officer under § 6320 or § 6330 is not an "inferior Officer of the United States" for purposes of the Appointments Clause. They are instead properly hired, pursuant to § 7804(a), under the authority of the Commissioner of Internal Revenue. The taxpayer's motion to remand was denied. In an opinion by Judge Williams, the Court of Appeals for the District of Columbia affirmed the Tax Court's decision. "[T]o be an 'Officer of the United States' covered by Article II, a person must 'exercis[e] significant authority pursuant to the laws of the United States.'" However, "Appeals employees' discretion is highly constrained. ... [T]he significance and discretion involved in the decisions seem well below the level necessary to require an 'Officer.'"

11. Just as a taxpayer is not required to file an amended return, the IRS is not required to accept and process an amended return. Roberts v. Commissioner, T.C. Memo. 2012-144 (5/21/12). The taxpayer filed a return for 2007 reporting zero taxable income and $6,000 of withheld taxes. The IRS processed the return and applied the $6,000 overpayment to the taxpayer's unpaid 1983 tax liability. Subsequently, the taxpayer filed an amended return for 2007 reporting nearly $59,000 of taxable income, but the IRS did not process the amended return. Instead the IRS sent a deficiency notice with respect to the same amounts reported on the amended return, and did not credit the $6,000 withholding against the 2007 taxes. The taxpayer argued that was improper for the IRS to apply the overpayment claimed on his original 2007 return to a prior year tax liability, but the Tax Court (Judge Foley) was unimpressed by the argument.

> Petitioner further contends that respondent was required to treat his amended 2007 return as superseding the original 2007 return. We disagree. Taxpayers are permitted to submit amended returns, but the Commissioner is "not statutorily required to *** [accept an amended return], or to treat an amended return as superseding an original return." Fayeghi v. Commissioner , 211 F.3d 504, 507 (9th Cir. 2000), aff'g T.C. Memo. 1998-297.

12. You can remove those mindless disclaimers from your emails when these proposed regulations become final (but not before). REG-13867-06, Promoting Abusive Tax Shelters, 77 F.R. 57055 (9/17/12). In the course of a comprehensive revision of the requirements for tax opinions, these proposed Circular 230 regulations include the following:

- The rigid covered opinion rules in current § 10.35 (which require that the written opinion contain a description of the relevant facts, the application of the law to those facts, and the practitioner's conclusion with respect to the law and the facts) are removed; these rules are replaced with a single standard for all written tax advice under proposed § 10.37. This standard requires that the practitioner must: (i) base the written advice on reasonable factual and legal assumptions; (ii) reasonably consider all the relevant facts that the practitioner knows or should know; (iii) use reasonable efforts to identify and ascertain the facts relevant on each Federal tax matter; (iv) not rely upon representations, statements, findings, or agreements (including projections, financial forecasts, or appraisals) if reliance on them would be unreasonable; and (v) not taken into account the possibility that a tax return will not be audited or that a matter will not be raised on audit. The determination of whether a practitioner has failed to comply with these requirements is based on all the facts and circumstances, not on whether each requirement is addressed in the written advice.

- Proposed § 10.35 provides that a practitioner must exercise competence when engaged in practice before the IRS (including providing written opinions), which includes the required knowledge, skill, thoroughness, and preparation necessary for the matter for which he is engaged. This complements the provision in § 10.51 that a practitioner can be sanctioned for incompetent conduct.
- Proposed § 10.36 conforms the "procedures to ensure compliance" with the removal of the covered opinion rules in current § 10.35, but expands these "procedures to ensure compliance" to include all of the provisions of Circular 230.
- Proposed § 10.1 provides that the Office of Professional Responsibility – as opposed to the IRS Return Preparer Office – would have exclusive responsibility for matters related to practitioner discipline.
- Proposed § 10.31 forbids practitioners from negotiating any taxpayer refunds, which specifically adds manipulation of any electronic refund process.
- Proposed § 10.82 extends the expedited disciplinary procedures for immediate suspension, but limits it to practitioners who have engaged in a pattern of willful disreputable conduct by failing to make an annual Federal tax return during four of five tax years immediately before the institution of the expedited suspension proceeding, provided that the practitioner is also noncompliant at the time the notice of suspension is served.

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

1. Social Security is cheaper for 2011, but the deficits grow. The Compromise Tax Relief Act of 2010, § 601, reduces the employee portion of the Old-Age, Survivors, And Disability Insurance Tax (OASDI) from 6.2 percent to 4.2 percent for calendar year 2011.

- The 4.2 percent rate also applies to the railroad retirement tax.

a. Congress giveth a little and taketh some of it back. IR 2011-124 (12/23/11). This news release highlights the two month reduction in payroll withholding for social security taxes from 6.2 percent to 4.2 percent and the complimentary reduction in self-employment taxes for the first two months of 2012 under The Temporary Payroll Tax Cut Continuation Act of 2011. The news release indicates that employers should implement the new payroll rate as soon as possible, but in any event no later than March 31, 2012. The news release also highlights the recapture tax that is imposed on employees who receive more than $18,350 in wages during the two-month extension period in the amount of an additional 2 percent income tax on wages in excess of $18,350 received during the two-month extension.

b. The recapture tax was repealed. The Middle Class Tax Relief and Job Creation Act of 2012 repealed the two-percent recapture tax included in the December 2011 legislation that effectively capped at $18,350 the amount of wages eligible for the payroll tax cut. As a result, the now-repealed recapture tax does not apply

2. Attorneys are employees of their professional corporation law firm. Donald G. Cave A Prof. Law Corp. v. Commissioner, T.C. Memo 2011-48 (2/28/11), *aff'd*, 109 A.F.T.R.2d 2012-1504 (5th Cir. 3/22/12). The court (Judge Marvel) held that Donald Cave, the principal attorney for the taxpayer S corporation engaged in law practice, associates of the firm, and a law clerk were employees for employment tax purposes. Donald Cave was the corporation's president, made corporate decisions, and received a percentage of legal fees. The court held that Cave's management services in the capacity of the corporation's president were not provided as an independent contractor. Numerous factors supported employment status for associate attorneys, hired by Cave in his purported activity as an "an attorney incubator"; they were found to be sufficiently under the control of the corporation, the corporation provided facilities, while the associates' compensation was on a percentage basis, they bore no risk of loss, the relationship was "continuous, permanent, and exclusive," there was no evidence that the associate attorneys provided services to anyone else, and the associate attorneys provided everyday professional tasks in the corporation's business. The court also denied independent contractor status under the safe harbor of § 530 of the 1978 Revenue Act finding no reasonable basis for the corporation to have treated the attorneys as independent contractors. The corporation was also required to pay failure to deposit tax penalties under § 6656.

a. **Affirmed on control and non-exposure to losses issues.** Donald G. Cave A Prof. Law Corp. v. Commissioner, 109 A.F.T.R.2d 2012-1504 (5th Cir. 3/22/12). The Fifth Circuit, in affirming the Tax Court, emphasized the factors of potential control by the firm of its associate attorneys and law clerk, as well as their non-exposure to losses. Judge Haynes concurred to note that, while the law clerk was "free" to do work for other attorneys outside the firm, "almost no evidence about [the clerk's] other work [was presented]," and continued, "we need not address here the tax treatment of a person who truly performs piece work for numerous business entities."

3. **Litigious attorney liable for employment taxes, no matter how many courts he tries.** Western Management, Inc. v. United States, 101 Fed. Cl. 105 (9/9/11). Attorney Kovacevich practiced through his wholly owned and operated corporation as an independent contractor. Taxpayer withdrew funds from the corporation as needed. In addition the corporation paid multiple personal expenses for the taxpayer and his wife. On instructions from the taxpayer, the corporation's accountant treated disbursements to the taxpayer as loans and did not file forms 1099 for any of the payments. In a 2003 decision (T.C. Memo. 2003-162, *aff'd*, 176 Fed. Appx. 778 (9th Cir. 2006)) the Tax Court held that Kovacevich was an employee and the corporation was liable for employment taxes, plus § 6662 penalties for the 1994 and 1995 tax years. The IRS subsequently prevailed against the taxpayer in a collection action in which the taxpayer asserted that checks credited against previous employment tax liabilities (also litigated in the Court of Federal Claims) should be applied to the 1994 and 1995 deficiencies. (T.C. Memo. 2009-160.) Kovacevich and the corporation filed a claim for refund of payments made by Kovacevich on the corporation's employment tax liabilities. The court granted summary judgment for the IRS, holding that the taxpayer could not re-litigate the prior Tax Court holdings that the taxpayer was an employee of the corporation. In addition, the court granted summary judgment to the Government, holding that Kovacevich was personally liable for the corporation's employment taxes, plus penalties and interest because the taxpayer operated the corporation as his alter-ego. Finally, the court held that the taxpayer's wife was also liable for the taxes and penalties under Washington community property law. There is a moral here.

4. **Voluntarily reclassify workers and pay less tax for last year only.** Ann. 2011-64, 2011-41 I.R.B. 503 (9/21/11). The IRS announced a voluntary classification settlement program that permits accepted applicants to agree to re-classify independent contractors as employees and pay reduced taxes for the prior year. The program augments the existing classification settlement program that allows eligible taxpayers under examination for worker classification issues. The program is available to taxpayers that currently and consistently classify workers as nonemployees and who filed all required Forms 1099 for the previous three years. The program is not available to taxpayers currently under audit for worker classification issues. A taxpayer accepted in to the program who agrees to prospectively treat workers as employees for future tax periods will be able to pay 10 percent of the employment tax liability that might have been due on compensation paid to workers in the most recent taxable year and will not be subject to penalties or interest on the liability. The taxpayer will not be subject to an employer tax audit with respect to worker classification for prior years. In addition, the taxpayer must agree to three year extension of the statute of limitations with respect to employment taxes for the first, second, and third calendar years beginning after the date on which the taxpayer has

Back to Table of Contents

agreed under the program to treat workers as employees. The voluntary program is significantly more generous than the current classification settlement program.

5. **Disregarded entities are regarded for employment tax purposes, except when they are disregarded.** T.D. 9554, Extending Religious and Family Member FICA and FUTA Exceptions to Disregarded Entitles, 76 F.R. 67363 (11/1/11). Several cases, sustaining the check the box regulations under *Chevron* deference, held that the sole owner of a disregarded entity was liable for the disregarded entity's employment taxes. See, e.g., *Littriello v. United States*, 484 F.3d 372 (6th Cir. 2007), and *McNamee v. Dept. of the Treasury*, 488 F.3d 100 (2d Cir. 2007). In the face of these litigation successes, Treasury adopted Reg. § 301.7701-2(c)(2)(iv) to provide that a disregarded entity is treated as a corporation for employment tax purposes and related reporting requirements, thereby shifting the liability away from the owner. However, treating the entity as a corporate employer would eviscerate provisions that exempt certain employment among family members and employment among religious persons who believe that Social Security taxes are contrary to the teachings of the religion or sect. Thus, temporary and proposed regulations, §§ 31.3121(b)(3)-1T(d) and 31.3306(c)(5)-1T(d) provide that a disregarded entity treated as a corporation for employment tax purposes will not be treated as a corporation for purposes of §§ 3121(b)(3) and 3306(c)(5), which provide an exemption from employment taxes for certain services performed by and for parents, children and spouses. Temporary and proposed regulations § 31.3127-1T(c) provide that a disregarded entity will not be treated as a corporation for purposes of § 3127, which provides an exception from FICA taxes where both the employer and employee are members of a religion that opposes participation in Social Security. Under each of these provisions, for purposes of applying the exemptions only, the owner of the disregarded entity will be treated as the employer. Further, temporary and proposed regulation § 301.7701-2T(c)(2)(iv)(A) is amended to clarify that that the owner of a disregarded entity remains subject to the backup withholding requirements of § 3406. The changes are effective for wages paid after 12/31/08, the effective date of Reg. § 301.7701-2(c)(2)(iv).

6. **The economy may be bad, but wages are going up.** Social Security News Release (10/19/11). The Social Security Administration announced that the Social Security wage base will increase in 2012 to $110,100, up from the wage base of $106,800. The $3,300 increase is due to an increase in average total wages.

a. **But good for the cost of nannies.** The Social Security Administration announced online that the exclusion for wages paid for domestic service in the employer's home goes up to $1,800 from $1,700 for 2012.

7. **"I'll gladly pay you Tuesday for a hamburger today."** T.D. 9566, Employer's Annual Federal Tax Return and Modifications to the Deposit Rules, 76 F.R. 77672 (12/14/11). Treasury has published proposed and temporary regulations providing for annual, rather than quarterly, deposits of employment taxes for employers who have estimated employment tax liability for wage withholding, social security and Medicare of $1,000 or less. When notified by the IRS, employers who qualify are required to file the annual Form 944 rather than the quarterly Form unless the employer opts out of annual reporting under the procedures of Rev. Proc. 2009-51, 2009-45 I.R.B. 625.

8. **The forms are in the mail doesn't establish delivery.** Martinez v. United States, 101 Fed. Cl. 686 (1/5/12). The taxpayer employed drivers as independent contractors in his sole-proprietorship trucking company. The taxpayer claimed relief from employment taxes for misclassified workers under § 530 of the Revenue Act of 1978, which requires that the taxpayer consistently treat workers as independent contractors and file appropriate tax returns. The taxpayer asserted that the required Forms 1099 were delivered to the IRS asserting that the timely delivery date can be established under the common-law mailbox rule, which provides that proof of timely mailing creates a presumption of delivery. The court noted that under § 7502(a) and (c) the only exceptions to requirements that returns be delivered are that a return will be deemed delivered on the date of the postmark, or on the date the mailing is registered [extended by regulation to certified mail]. The court added that even if the taxpayer could invoke a common-law mailbox rule, the evidence was not sufficient to prove a timely and proper mailing.

9. Employment tax liability depends upon which form you can use. LaFlamme v. Commissioner, T.C. Memo. 2012-36 (2/6/12). The taxpayer, a self-employed individual, deducted her contributions to her qualified defined benefit pension plan on her Schedule C, rather than on line 26 of her Form 1040 and claimed that her income from self-employment for purposes of employment tax liability was thereby reduced by the allowable § 162 deduction. Section 404(a)(8) allows a self-employed individual to deduct contributions to qualified plans under §§ 162 or 212. Section 1402 defines net income from self-employment subject to the self-employment tax of § 1401 as gross income "from any trade or business" less the deductions allowed by Subtitle A "which are attributable to such trade or business." The court (Judge Vasquez) agreed with the IRS that that the taxpayer's pension contribution is "not attributable to her trade or business." The court also indicated that the special rule of § 404(a)(8) does not apply outside of the context of that section. Thus, the taxpayer's pension contribution was not allowed as a deduction on her Schedule C in computing business income. The court declined to impose penalties under § 6662 finding that the taxpayer acted in good faith in the mistaken belief that she was entitled to deduct the pension contribution on her Schedule C.

10. S corporation "John Edwards gambit" dividends may be treated as wages. David E. Watson, P.C. v. United States, 714 F. Supp. 2d 954 (S.D. Iowa 5/27/10). Using a common tax reduction device, David Watson formed an S corporation that was a member of Watson's accounting firm. The S corporation contracted with the accounting firm to provide services. Watson was paid a salary of $24,000 as an employee of the S corporation, on which the S corporation paid employment taxes. The remainder of the S corporation income, approximately $200,000 per year, was distributed to Watson as a dividend, not subject to employee taxes. The IRS recharacterized the dividends as wages. The S corporation paid an assessment and brought a refund action. In a motion for summary judgment the S corporation asserted that its intent controls whether amounts paid are wages and that it intended to pay dividends in the amount of cash on hand after the payment of wages. Citing a long line of authorities in support of its position, the District Court held that the S corporation's "self proclaimed intent" to pay salary does not limit the government's ability to recharacterize dividends as wages. The court indicated that whether amounts paid to Watson were remuneration for services is a question of fact.

- The court's opinion concluded with the following passage:

> In support of its Motion for Summary Judgment, Plaintiff points the Court to the following oft-cited statement of Judge Learned Hand:
>
> Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as law as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.
>
> See Pl.'s Reply Br. at 5 n. 2 (quoting *Commissioner of Internal Revenue v. Newman*, 159 F.2d 848, 850-51 (2d Cir.1947) (L. Hand, J., dissenting)). While the Court agrees fully with Judge Learned Hand, it would remind Plaintiff of Justice Oliver Wendell Holmes' succinct, yet equally eloquent statement in *Compania General de Tabacos de Filipinas v. Collector of Internal Revenue*: "Taxes are what we pay for civilized society." 275 U.S. 87, 100 (1927) (Holmes, J., dissenting). Indeed, "the greatness of our nation is in no small part due to the willingness of our citizens to honestly and fairly participate in our tax collection system." *Manley v. Commissioner of Internal Revenue*, T.C. Memo 1983-558 (Sept. 12, 1983). Thus, while Plaintiff is free to structure its financial affairs in such a way as to avoid paying "more [taxes] than the law demands," Plaintiff is not free to structure its financial affairs in a way that avoids paying those taxes demanded by the law. In this case, the law demands that Plaintiff pay employment taxes on "all remuneration for employment," and there is clearly a genuine issue of material fact as to whether the funds paid to Watson, in actuality, qualify as such.

Back to Table of Contents

a. Since the judge gave the IRS everything it asked for, will the IRS go for the whole kit and caboodle the next time? David E. Watson, P.C. v. United States, 757 F. Supp. 2d 877 (S.D. Iowa 12/23/10). On the merits, Judge Pratt rejected the taxpayer's claim that the wages subject to employment tax were limited to the $24,000 salary formally paid to the sole shareholder/sole employee. In addition to the "salary" in each of the years in question, the corporation distributed approximately $175,000 of "profits," pursuant to a corporate resolution authorizing "payment to Watson of 'dividends in the amount of available cash on hand after payment of compensation and other expenses of the corporation.'" Citing *Joseph Radtke, S.C. v. United States*, 712 F. Supp. 143 (E.D. Wis. 1989), *Spicer Accounting, Inc. v. United States*, 918 F.2d 90 (9th Cir. 1990), and *Veterinary Surgical Consultants v. Commissioner*, 117 T.C. 141 (2001), as particularly persuasive, the court concluded that "'characterization of funds disbursed by an S corporation to its employees or shareholders turns on an analysis of whether the payments at issue were made ... as remuneration for services performed.'" After examining the facts, the court concluded that the reasonable amount of Watson's compensation for each of the years at issue was $91,044, increasing the $24,000 salary amount by the full amount of the $67,044 that the corporation claimed was a § 1368 distribution, thus upholding in full the government's position.

b. Reasonable compensation can go up as well as down. David E. Watson, P.C. v. United States, 668 F.3d 1008 (8th Cir. 2/21/12). In affirming the District Court, the Court of Appeals agreed with the IRS that the factors used by courts to assess reasonable compensation in the context of deductions are applicable to determine whether payments are in fact remuneration for FICA purposes. The court indicated that "in light of all the facts and circumstances of the case, scrutinizing compensation for its reasonableness may guide a court in characterizing payments for FICA tax purposes." Assessing the facts, the Court of Appeals concluded that the District Court did not clearly err in treating additional payments to the taxpayers as remuneration for services. The court also rejected the taxpayer's argument that under *Pediatric Surgical Assocs., P.C. v. Commissioner*, T.C. Memo. 2001-81, the intent of the payor is controlling, noting that *Pediatric Surgical* did not involve a question of reasonableness.

11. NOLs do not reduce self-employment income. Decrescenzo v. Commissioner, T.C. Memo. 2012-51 (2/27/12). The taxpayer was assessed deficiencies when he failed to file a return of income from self-employment as an accountant. The Tax Court (Judge Marvel) held – yet again — that § 1402(a)(4) prohibits a taxpayer from offsetting net earnings from self-employment with an NOL carryforward or carryback.

12. Tax-exempt employer is not subject to excise tax on qualified plan reversions. Research Corporation v. Commissioner, 138 T.C. No. 7 (2/29/12). Section 4980(a) imposes a 20 percent tax on the amount of any reversion to the employer from a qualified plan. However, § 4980(c)(1) excludes from the definition of a qualified plan, a plan "maintained by an employer if such employer has, at all times, been exempt from tax under subtitle A." Research Corporation received a reversion from its qualified plan in the amount of $4,411,395, but reported a taxable reversion under § 4980 of only $14,055 asserting that the reported amount reflected the portion of its income that was subject to the unrelated business income tax. In a case of first impression, the Tax Court (Judge Haines) rejected the IRS assertion that, because the tax-exempt corporation was subject to tax on unrelated business income, it was not at all times exempt from tax under subtitle A. The court cited the language of § 501(b), which provides that a § 501(c)(3) organization that is subject to the unrelated business income tax "shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes." Thus the court held that Research Corporation was to be treated as exempt from tax at all times for purposes of § 4980(c)(1). The court also concluded that Research Corporation overpaid its taxes on the portion that it treated as a reversion, but that the court lacked jurisdiction to order a refund.

13. The story line is just a rerun. DeCrescenzo v. Commissioner, T.C. Memo. 2012-51 (2/27/12). The Tax Court held – yet again — that § 1402(a)(4) prohibits a taxpayer from offsetting net earnings from self-employment with an NOL carryforward or carryback.

14. Full-time resident horse farm workers don't have enough independence from the horse-mistress. Twin Rivers Farm, Inc. v. Commissioner, T.C. Memo. 2012-184 (7/2/12). The Tax Court (Judge Ruwe) denied the subchapter S corporation's petition for redetermination of the IRS's determination of employment status for two farm workers on the taxpayer's Tennessee horse farm. In spite of assertions by the taxpayer's sole shareholder that she did not exercise control over the two workers, the court noted that to maintain the requisite degree of control to establish employee status the principal need not directly control the worker, it is sufficient that the principal has the right to do so. The court indicated that by the nature of the work relationship, it was likely that the shareholder had the right to exercise control. The workers were using the taxpayer's equipment, caring for the corporation's principal assets, and living full time in a trailer on the taxpayer's property. The court pointed out that if the workers were not exercising their duties appropriately that the shareholder would certainly have intervened with direction. The court also pointed to the fact that the workers were receiving a regular weekly salary for their services and were long-term employees who resided on the farm. In addition, the taxpayer maintained workers compensation insurance and covered the workers' necessary job-related expenditures. The court also held the taxpayer liable for penalties under § 6651(a)(1) for failure to file the required Form 943 for employers of agricultural workers and penalties under § 6656 for failure to make timely employment tax deposits.

15. Atlantic Coast Masonry, Inc. v. Commissioner, T.C. Memo 2012-233 (8/13/12). In spite of the fact that construction masons and laborers were paid in cash by the taxpayer on a piece-work basis, the workers were held to be employee by Judge Jacobs. The Tax Court noted that the workers were skilled craftsmen who did not require direct supervision. Nonetheless, instruction from the taxpayer on the nature of the work and requirements for completion constituted control over the workers. "An employer need not 'stand over' the employee to control an employee." The court also indicated that the workers did not share in profits and losses notwithstanding the piece-work nature of the workers' compensation, and that the factor supported employee status. Section 530 relief was denied because the taxpayer failed to file Forms 1099 with respect to the workers. The taxpayer was also held liable for § 6651 penalties for failure to file required employment tax returns and § 6656 penalties for failure to pay required employment tax deposits. The court held that the taxpayer failed to demonstrate reasonable cause for the absence of filings.

B. Self-employment Taxes

C. Excise Taxes

1. Disregarded entities are regarded as corporations for excise taxes. T.D. 9553, Disregarded Entities; Excise Taxes and Employment Taxes, 76 F.R. 66181 (10/26/11). The Treasury has finalized temporary regulations issued in 2009 that provide that a disregarded entity is treated as an entity separate from its owner for purposes of Federal tax liabilities of the entity for any period that it was not a disregarded entity, Federal tax liabilities of any other entity for which the disregarded entity is liable, and refunds or credits of federal tax. Reg. § 301.7701-2(c)(2)(iv)(B) provides that a disregarded entity is treated as a corporation for purposes of employment tax and income tax withholding, and Reg. § 301.7701-2(c)(2)(v)(B) provides that a disregarded entity is treated as a corporation for purposes of excise taxes described in Reg. § 301.7701-2(c)(2)(v)(A). The preamble to the regulation states that the "final regulations retain the rule that excise taxes imposed on amounts paid for covered services (such as air transportation) apply to amounts paid between state law entities for such services (unless a statutory exception applies)." Thus, for example, payments by the owner for air transportation to a disregarded entity are subject to excise taxes under § 4261.

2. The price of a tan goes up even in disregard of the hazard from which the owner is protected. T.D. 9596, Disregarded Entities and the Indoor Tanning Services Excise Tax 77 F.R. 37806 (6/25/12). Temp. and Prop. Reg. § 1.1361-4T(a)(8)(iii) adds the 10 percent excise tax on indoor tanning services of § 5000B is added to the list of excise taxes for which disregarded entities (QSub or single owner business entity) that are treated as separate entities.

3. **Roll your own, inhale, and pay the tax.** Section 100122 of the Transportation Act would amend Code § 5702(d) to add to the tobacco excise tax any person who for commercial purposes makes available to the consumer a machine that rolls cigarettes, cigars, or other tobacco products. Previously the tax only applied to manufacturers of cigarettes and cigars who actually rolled the product, but did not apply to consumers who rolled their own. This change would add to the tobacco excise tax establishments that provided access to commercial grade rolling equipment to consumers who purchased the tobacco and paper from the retailer and fed it into the machine provided by the retailer, obtaining cigarettes at much lower cost free of the excise tax.

4. **The IRS rejects a (former) Court of Claims limitation on retroactive application of rulings.** AOD 2012-002 (9/12/12). The IRS announced its nonacquiescence in *International Business Machines Corp. v. United States*, 343 F.2d 914 (Ct. Cl. 1965), which held that the IRS could not apply a changed position on an excise tax issue prospectively from the date of revocation to a taxpayer whose erroneous favorable ruling was revoked, but retroactively as to another taxpayer. The Court of Claims in *IBM* held that it was an abuse of discretion to treat two competitors differently with respect to excise taxes on the same type of equipment.

XII. TAX LEGISLATION

A. Enacted

1. The **Patient Protection and Affordable Care Act** ("PPACA" – pronounced "pee-pac-a" or "Obamacare"), P.L.111-148, was signed by President Obama on 3/23/10, and H.R. 4872, the **Health Care and Education Reconciliation Act of 2010** ("2010 Health Care Act" or "2010 Reconciliation Act"), P.L. 111-152, was signed by President Obama on 3/30/10.

a. **The 2010 Health Care Act is constitutional, but the "penalty" is not a "tax."** Thomas More Law Center v. Obama, 651 F.3d 529 (6th Cir. 6/29/11) (2-1). The Sixth Circuit Court of Appeals, in an opinion by Judge Martin, upheld the constitutionality of the Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (2010), amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029. The majority opinion upheld the Act under the commerce clause. Judge Sutton's concurring opinion, which also "delivered the opinion of the court in part" also concluded that the Act was constitutional under the Commerce clause, but held that the Act was not an exercise of the taxing power – the penalty for not purchasing health insurance was not a tax. An opinion by Senior District Judge Graham, concurring in part and dissenting in part, also held that the Act was not an exercise of the taxing power but would have held the Act unconstitutional as beyond Congress's power to regulate commerce.

b. **But, on the other hand, the Eleventh Circuit holds that the individual mandate is unconstitutional.** Florida v. Department of Health & Human Services, 648 F.3d 1235 (11th Cir. 8/12/11) (2-1). The Eleventh Circuit held that Congress exceeded its authority by requiring Americans to buy coverage, but also ruled that the rest of the wide-ranging law could remain in effect. The case stems from a challenge by twenty-six states which had argued the individual mandate, set to go into effect in 2014, was unconstitutional because Congress could not force Americans to buy health insurance or face the prospect of a penalty. The majority stated:

> This economic mandate represents a wholly novel and potentially unbounded assertion of congressional authority: the ability to compel Americans to purchase an expensive health insurance product they have elected not to buy, and to make them re-purchase that insurance product every month for their entire lives.

c. **Does anyone really care what D.C. Circuit thinks when the issue is already up on certiorari?** Seven-Sky v. Holder, 661 F.3d 1 (D.C. Cir. 11/8/11). The Court of Appeals for the District of Columbia (2-1) upheld the constitutionality of the minimum essential health care coverage requirement of § 1501 of the 2010 Patient Protection and Affordable Health Care Act, codified at Code § 5000A as an exercise of Congress's power under the Commerce clause. The suit was not barred by the Anti-Injunction Act because the suit

Back to Table of Contents

involved a penalty unconnected to a tax liability. Judge Kavanagh dissented as to jurisdiction because he would have held that the AIA barred the suit.

d. **When President Obama said that the "individual mandate" was not a tax, Justices Kennedy, Scalia, Thomas and Alito thought he was being serious, but the Chief Justice and Justices Ginsburg, Breyer, Sotomayor and Kagan knew that, as usual, he was just fooling with us.** National Federation of Independent Business v. Sebelius, 132 S. Ct. 2566 (6/28/12). On certiorari to the Eleventh Circuit, the Chief Justice delivered the opinion for the Court which held: (1) that the suit to declare the individual mandate unconstitutional was not barred by the Anti-Injunction Act because Congress indicated that it did not want it to be so barred (9-0); (2) that the individual mandate was unconstitutional as an exercise of congressional power under the Commerce Clause (5-4); and (3) that the individual mandate was valid as a tax – but not a direct tax – under the Taxing Clause (5-4). With respect to the Direct Tax Clause, the Chief Justice stated:

> A tax on going without health insurance does not fall within any recognized category of direct tax. It is not a capitation. Capitations are taxes paid by every person, "without regard to property, profession, *or any other circumstance*." *Hylton, supra*, at 175 (opinion of Chase, J.) (emphasis altered). The whole point of the shared responsibility payment is that it is triggered by specific circumstances — earning a certain amount of income but not obtaining health insurance. The payment is also plainly not a tax on the ownership of land or personal property. The shared responsibility payment is thus not a direct tax that must be apportioned among the several States.

- There was some more stuff about Congress lacking the power to force states to expand Medicaid upon pain of denial of all federal aid to states for Medicaid, which was decided 7-2.

2. The **America Invents Act of 2011**, P.L. 112-29, was signed by President Obama on 9/16/11. Section 14 of the Act provides that "any strategy for reducing, avoiding, or deferring tax liability, whether known or unknown at the time of the invention or application for patent, shall be deemed insufficient to differentiate a claimed invention from the prior art." This provision does not apply to computer tax return preparation products. It will not affect patents already issued.

3. The **Three Percent Withholding Repeal and Job Creation Act**, P.L. 112-56, was signed by President Obama on 11/21/11.

4. The **Temporary Payroll Tax Cut Continuation Act of 2011**, P.L. 112-78, was signed by President Obama on 12/23/11.

5. The **Middle Class Tax Relief and Job Creation Act of 2012**, P.L. 112-96, was signed by President Obama on 2/22/12. The new law also repeals the two-percent recapture tax included in the December 2011 legislation that effectively capped at $18,350 the amount of wages eligible for the payroll tax cut. As a result, the now-repealed recapture tax does not apply.

6. The **Moving Ahead for Progress in the 21st Century Act** (the "Transportation Act"), P.L. 112-140, was signed by President Obama on 7/6/12. Section 100122 of the Transportation Act amends Code § 5702(d) to add to the tobacco excise tax any person who for commercial purposes makes available to the consumer a machine that rolls cigarettes, cigars, or other tobacco products.

B. Pending

1. The **American Jobs Act of 2011** was orally signed by President Obama on 9/8/11. It will reduce the unemployment rate to 4 percent, cause the oceans to recede and cure cancer. Lacking are a written bill (because the Congressional Budget Office perversely refuses to score speeches) and the trivial detail of congressional voting (rendered irrelevant by President Obama's multiple repetitions of the necessity of immediate passage of the yet-unwritten bill, which Congress perversely failed to do on 9/9/11).

Back to Table of Contents

RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

For the Idaho State Tax Institute

I. ACCOUNTING 1

A. Accounting Methods 1
B. Inventories 3
C. Installment Method 3
D. Year of Inclusion or Deduction 3

II. BUSINESS INCOME AND DEDUCTIONS 5

A. Income 5
B. Deductible Expenses versus Capitalization 9
C. Reasonable Compensation 15
D. Miscellaneous Deductions 17
E. Depreciation & Amortization 22
F. Credits 26
G. Natural Resources Deductions & Credits 28
H. Loss Transactions, Bad Debts, and NOLs 28
I. At-Risk and Passive Activity Losses 28

III. INVESTMENT GAIN AND INCOME 33

A. Gains and Losses 33
B. Interest, Dividends, and Other Current Income 42
C. Profit-Seeking Individual Deductions 42
D. Section 121 43
E. Section 1031 43
F. Section 1033 43
G. Section 1035 43
H. Miscellaneous 43

IV. COMPENSATION ISSUES 43

A. Fringe Benefits 43
B. Qualified Deferred Compensation Plans 45
C. Nonqualified Deferred Compensation, Section 83, and Stock Options 45
D. Individual Retirement Accounts 46

V. PERSONAL INCOME AND DEDUCTIONS 47

A. Rates 47
B. Miscellaneous Income 47
C. Hobby Losses and § 280A Home Office and Vacation Homes 50
D. Deductions and Credits for Personal Expenses 50
E. Divorce Tax Issues 52
F. Education 53
G. Alternative Minimum Tax 53

VI. CORPORATIONS 53

A. Entity and Formation 53
B. Distributions and Redemptions 53
C. Liquidations 53
D. S Corporations 53
E. Mergers, Acquisitions and Reorganizations 58
F. Corporate Divisions 62
G. Affiliated Corporations and Consolidated Returns 63
H. Miscellaneous Corporate Issues 63

VII. PARTNERSHIPS 63

A. Formation and Taxable Years 63
B. Allocations of Distributive Share, Partnership Debt, and Outside Basis 69
C. Distributions and Transactions Between the Partnership and Partners 72
D. Sales of Partnership Interests, Liquidations and Mergers 72
E. Inside Basis Adjustments 72
F. Partnership Audit Rules 72
G. Miscellaneous 79

VIII. TAX SHELTERS 81

A. Tax Shelter Cases and Rulings 81
B. Identified "tax avoidance transactions" 87
C. Disclosure and Settlement 87
D. Tax Shelter Penalties, etc. 87

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING 90

A. Exempt Organizations 90
B. Charitable Giving 92

X. TAX PROCEDURE 98

A. Interest, Penalties and Prosecutions 98
B. Discovery: Summonses and FOIA 103
C. Litigation Costs 104
D. Statutory Notice of Deficiency 104
E. Statute of Limitations 104
F. Liens and Collections 115
G. Innocent Spouse 117
H. Miscellaneous 118

XI. WITHHOLDING AND EXCISE TAXES 123

A. Employment Taxes 123
B. Self-employment Taxes 128
C. Excise Taxes 128

XII. TAX LEGISLATION 129

A. Enacted 129
B. Pending 130

Back to Table of Contents

Texas State Tax
For the Oil and Gas Industry

Including
Updates for 2012

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Back to Table of Contents

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Back to Table of Contents

Table of Contents

Chapter I. Overview 1
A. Economic Development in Texas 1
B. Texas State Tax for the Oil and Gas Industry 2
C. Sales and Use Tax. 2
D. Credit for Early and Timely Payments. 7
E. Oil and Gas Well Servicing Tax. 8
F. Oil and Gas Production / Severance Taxes. 9
G. Fuel Taxes and Fees. 11
H. Electronic Funds Transfer. 15
I. Late Filing Penalties. 16
J. Tax Clearance Letters. 16
K. Prepayment for August 2013. 16
Chapter II. Taxable Services 15
A. Introduction 15
B. Information Services. 15
C. Real Property Services. 16
D. Landmen Services. 17
E. Drilling/Workover/Repair. 18
F. New Construction. 20
G. Processed Materials. 20
H. Services Performed on Wells. 21
I. Well Servicing Tax. 29
Chapter III. Exemptions 39
A. State Tax Exemptions for the Oil and Gas Industry 39
B. Sales & Use Tax Exemptions 39
C. Accepting an Exemption Certificate. 39
D. Resale Exemption. 41
E. Resale Certificates. 42
F. The Manufacturing Exemption 43
G. Opportunities and Pitfalls. 50
H. Exemption for Items Used to Capture, Transport and Sequester CO_2. 52
I. Gas and Electricity Exemption. 53
J. Common Property Ownership Transfers. 55
K. Water-Related Exemptions. 56
L. Production/Severance Tax Exemptions. 57
M. Oil Production Tax Exemptions. 59
N. Natural Gas Tax Exemptions. 60
Chapter IV. Oil and Gas Severance Tax 62
A. Introduction 62
B. Oil Production Tax. 62
C. Natural Gas Production Tax. 63
D. Drip Gas, Compressor and Deydrator Liquids. 65
Chapter V. Texas Franchise (Margin) Tax 66
A. Introduction 66

B. Tax Imposed 68
C. Nontaxable Entities 71
D. Exempt Entities 74
E. Passive Entities 76
F. Forfeiture Provisions 78
G. Special Rules for Small Entities 79
H. Electing a Deduction 79
I. Tax Rate 80
J. Credits 84
K. Reporting and Payment 85
L. Extensions 85
M. Amended Reports 88
N. Exit Tax 88
O. Total Revenues 88
P. General Reductions and Exclusions 90
Q. Revenue Consistency 94
R. Cost of Goods Sold Deduction 94
S. Nondeductible Costs 103
T. Arms-Length Requirement 104
U. Capitalizing COGS 104
V. Compensation Deduction 105
W. Eligible Persons 105
X. Wages & Cash Compensation 106
Y. Benefits 109
Z. Not Benefits. 109
AA. Health Care Incentives 110
BB. Military Compensation 110
CC. Single Factor Apportionment 111
DD. Unitary Affiliates without Nexus 111
EE. Texas Gross Receipts 111
FF. Combined Reporting 124
GG. Reporting Entity 132
HH. Consistency Requirements 134
II. Combined Reporting for Entities Starting Business 135
JJ. Combined Reporting for Entities Ceasing Operations 136
KK. Joint and Several Liability 136
LL. Water's Edge Reporting 137
MM. Oil & Gas Industry Summary 138
Chapter VI. Selected Issues 144
A. Introduction 144
B. Property Tax 144
C. Fuel Tax 144
D. Enforcement and Collection of Motor Fuel Taxes 147
E. Deferred Payments and Accelerated Credits 148
F. Biodiesel and Renewable Diesel Fuel Notices 148
G. Used Oil Collection Centers. 149

Back to Table of Contents

Chapter I. Overview

A. Economic Development in Texas

Recent exploration and development in the oil and gas industry, particularly in comparison with the general overall economy, has brought increased scrutiny to taxation of the oil and gas industry.

The Eagle Ford Shale discoveries have increased oil production by more than six times from 2010 to 2011 with 2011 at 28,315,540 bbls (barrels). Production of oil and condensate is almost 50 million barrels. This is expected to double in 2012. Gas production had doubled and condensate tripled from 2010 to 2011. A study by the University of Texas at San Angelo showed total economic output impact in 2011 in the 20-county study region exceeded $25 billion.

Other projects in Uvalde, Bexar, Victoria, San Patricio, Jim Wells and Nueces counties have also significantly enhanced production.

This has brought additional jobs and economic development to these areas, including:

- Drilling and completion work;
- Extraction services;
- Pipeline construction;
- Refinery operations;
- Land lease payments;
- Royalty payments; and
- Right of way payments.

These activities have affected state tax revenues in Texas.[1] According to the Texas Comptroller, the price of crude oil topped $100 for the first time in seven months in January 2012, and has since crept up to $109 in February, then eased back during April, falling below $95 in mid-May.

Severance Taxes. High crude prices translate into high gasoline and diesel prices for consumers and businesses, with nationwide gasoline prices are averaging about $3.75 per gallon of regular in June 2012. Texas prices are generally slightly lower than the national average. The Energy Information Administration (EIA) forecasts gas prices will continue to remain relatively level through 2013.

Since Texas is the nation's largest energy producer, rising prices can have near-term beneficial effects by attracting increased production, resulting in increased collections of state production or "severance" taxes. The state's 2012-13 Certified Revenue Estimate forecasts that $400 million more will be transferred into the Economic Stabilization Fund (a/k/a the "rainy day fund") during 2012-13 than during the last biennium, due to anticipated production increases.

Motor fuels taxes. The changes in price don't directly affect the amount of fuel taxes collected, but may cause drivers to purchase more or less fuel. Texas drivers pay 38.4 cents in state and

1 *See, e.g.*, Fiscal Notes, June 12, 2012. http://www.window.state.tx.us/comptrol/fnotes/fn1205/oil-prices.php.

Back to Table of Contents

federal motor fuel taxes on every gallon purchased.[2]

Sales taxes: As production increases, not only do taxable services and sales of goods increase, but taxpayers purchase more equipment and vehicles, stimulating state and local sales tax revenues. The Texas mining sector, primarily oil and gas production, added 5,700 jobs in January 2012, and 38,000 jobs in the twelve month period ended January 31, 2012.

B. Texas State Tax for the Oil and Gas Industry

Various types of Texas state taxes apply to the various stages of oil and gas production and to the various players involved. The Texas state taxes span from the sales and use tax on supplies and services, to the oil & gas severance tax on production, to the IFTA and motor fuels taxes on the finished products. This outline addresses several of the Texas state taxes that apply in the oil and gas industry, with a concentration on taxable services, exemptions and sales tax issues specific to the industry.

C. Sales and Use Tax.

Although many types of taxes apply to the oil and gas industry, the most significant tax is the sales and use tax. The Texas Limited Sales, Excise and Use Tax Act imposes a tax on the sale, lease or rental of tangible personal (touchable, movable) property and on certain specified services.[3] Sales and Use taxes are complementary. Together, they are intended to uniformly tax transactions only once whether in or out of Texas. Sales and use taxes account for 26% of all state revenues, roughly five times the contribution of any other tax.

Sales Tax. Texas imposes sales tax on retail sales of taxable items in Texas. The state rate is 6.25% as of July 1, 1990. Various local sales taxes may be imposed in addition to this tax. The maximum combined tax rate for local taxes may not exceed 2% at any location. Therefore, the maximum possible sales tax rate is 8.25%.

Example. Big Oil Company purchases an office desk from a supplier located in Waco. This transaction is subject to sales tax. The law treats Big Oil Company as the consumer of the desk.

Use Tax. This tax applies when items are acquired out-of-state and brought into Texas. Texas law requires a Texas retailer to collect the sales tax at the time of sale. Since a non-Texas retailer makes the sale, Texas sales tax would not be collected at the time of sale. Also, the seller would usually not collect the origin state's sales tax because the item is destined for Texas. This transaction is subject to the use tax.

Without the use tax, persons could purchase items from an out-of-state retailer, use the items in Texas and escape paying any tax. The use tax prevents this abuse and places out-of-state vendors on an even playing field with Texas vendors. The use tax applies to "any taxpayer who purchases tangible personal property from any retailer for storage, use or other consumption in Texas."[4]

[2] 20 cents in state tax and 18.4 cents in federal tax.
[3] Chapter 151 of the Texas Tax Code.
[4] Texas Tax Code § 151.101.

Back to Table of Contents

Example. Big Oil Company purchases an office desk from a vendor located in Tulsa, Oklahoma for use at its offices in Houston, Texas. Big Oil Company owes Texas use tax on the office desk. If sales tax was legally owed and paid in Oklahoma, Big Oil Company would be entitled to a sales tax credit for the tax paid in the other state. If the Oklahoma retailer lacks nexus with Texas, Big Oil Company must accrue and remit the use tax.

Joint Liability. The Texas sales and use tax is primarily a debt of the purchaser of the goods or services. However, the seller or service provider shares liability due to its obligation to collect and remit the tax. The Comptroller may pursue either the buyer or the seller for the unpaid tax.[5]

Goods and Services Subject to Sales and Use Tax. Texas imposes sales tax on the "sales price" of each "sale" of a "taxable item" in Texas.[6] The tax is not imposed when an exemption from the tax applies.

Presumptions. The tax law presumes that all retail sales or uses of tangible personal property are taxable transactions. Contrast this with the performance of taxable services where this presumption does not lie.

"Sales Price." This is the amount for which the item is sold, leased or rented without a deduction for the cost of transportation and other costs.

Separately Stated Items. Separately stating items, such as freight or transportation and similar costs will not convert them to non-taxable charges. They will remain a component of the sales price.

Exception for certain charges. Certain charges, if separately stated, are not subject to the tax. These include discounts, refunds, returns, finance charges and trade-ins.[7]

"Sale." The sales tax taxes sales. A sale occurs when three elements are present:

- A transfer of title or possession,
- Of a taxable item including tangible personal property,
- Done for consideration (i.e., money or some other value).

The statute specifically states that the following transactions are sales when done for value (or consideration):

- Title. Transferring title of tangible personal property is a sale. A sale still occurs if the seller keeps possession of the item sold, but passes title.
- Possession. Transferring possession of tangible personal property is also a sale if the possession is in lieu of transferring title or constitutes a barter or exchange.
- Segregation. Merely segregating items in contemplation of transferring title or possession does not create a sale.[8]
- Exchanges. The exchange or barter of tangible personal property is a sale.

[5] *See* Bullock v. Delta Indus. Constr. Co., Inc., 668 S.W.2d 502 (Tex. Civ. App. – Austin 1984, no writ).
[6] Texas Tax Code § 151.051.
[7] Texas Tax Code § 151.007.
[8] Note that earlier versions of the statute treated segregation as a sale.

- Trade-Ins. A trade-in to reduce the purchase price of a taxable item is a taxable barter, but only if the item given by the buyer is not sold in the seller's regular course of business.[9]
- Leases or Rentals. The lease or rental of tangible personal property is a sale. There are two broad categories of leases: operating leases and financing leases.[10] Both are taxable. However, the amount of tax and when it is paid is different for each.
- Service. Performing a taxable service. Taxable services are listed in the Texas Tax Code.[11]
- Production. Producing, fabricating, processing, printing or imprinting tangible personal property for consumers who directly or indirectly furnish the materials used in the production, fabrication, processing, printing or imprinting. Some examples include developing photographs, tailoring, assembling toys and furniture, printing, calligraphy and catering.
- Social clubs. Furnishing and distributing tangible personal property by a social club or fraternal organization to anyone.
- Food. Furnishing, preparing or serving food, meals or drinks.
- Lien. Sale of property where the seller retains a security interest in the item sold.
- Special Orders. Sale of property under a customer's special orders.
- Divergent Use. If a company removes an item from its inventory for its own use, it may owe sales tax on the cost of the materials used to build the item.[12]

"Taxable Item". "Taxable Item" means tangible personal property and taxable services.

Tangible personal property. Tangible Personal Property is property that can be weighed, measured, felt or touched or that is perceptible to the senses in any other manner, including computer programs[13] and digital products.[14]

Legislative Update. Oilfield portable units, which include trailers designed to be used as temporary lodging or temporary office space, are now excluded from being taxed as motor vehicles, but only when used exclusively at oil, gas, water disposal or injection well sites. These units are subject to sales and use tax under Chapter 151 of the Tax Code. Portable units used elsewhere remain taxed as motor vehicles.[15] They are not subject to hotel occupancy taxes.[16]

Taxable Services. These are the services specifically listed as taxable under the statute. They are discussed in more detail in Chapter II.

Essence of the Transaction Test. Texas courts look at the buyer's intent to determine whether goods or services are being sold. In some cases, the parties' intent may also bear on whether state

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9 Comptroller Rule 3.302(g).
10 Comptroller Rule 3.294(a)(1).
11 Texas Tax Code § 151.0101.
12 Texas Tax Code § 151.3181 covers divergent uses of tangible personal property in the manufacturing process. This special divergent use rule is discussed later in these materials.
13 Texas Tax Code § 151.009.
14 Effective Sept. 1, 2001. Added by S.B. No. 1125 (77th Legis. Session) in 2001.
15 House Bill 3182 (Effective Sept. 1, 2011).
16 House Bill 3182 (Effective Sept. 1, 2011).

Back to Table of Contents

law characterizes the item as tangible personal property or real property.[17]

Example. In *Williams and Lee Scouting Service, Inc. v. Calvert*,[18] the taxpayer sold oil well and field reports on computer tape to its customers. The court held the sale was for a non-taxable service and did not constitute the sale of tangible personal property (i.e., the computer tape). The "essence of the transaction" was the purchase of the information contained on the tape, and because information services were not yet taxable in Texas, the Court held that the transaction was, in essence, a non-taxable service.

Important Note: The "essence of the transaction" doctrine is an all-or-nothing rule of law. A charge is either completely taxable or it is completely non-taxable. Therefore, if a taxpayer is able to show that the basic purpose of the transaction is the performance of a non-taxable service, sales tax is not due even on the portions of the service which are admittedly taxable. This is apparently true even if the charge was separately stated.

Entity Concept. Texas law follows the separate entity concept. The law treats each person or entity as a separate taxpayer regardless of whether they are owned or controlled by the same person(s). Accordingly, transactions between related taxpayers are usually subject to the sales or use tax. This includes, for example, the lease of equipment from an owner to his wholly-owned corporation.

Sales to Affiliates. Sales between two separate corporations, even if they are related as brother-sister or parent-subsidiary, are subject to sales and use tax.

Division Transfers. Sales or transfers between two divisions or agencies of the same corporation are not subject to sales tax even though the two divisions may treat the transfer as a sale and purchase on their records.

Retailers v. Purchasing Agents. Normally, a retailer purchases items tax-free and resells them for a profit and collects sales tax on the retail price. However, certain selling relationships are treated differently. The Comptroller appears to have a strict view of when companies may use a purchasing agent. This narrow view may create unintended, potential sales tax liabilities for companies that use an affiliate as a central buying agent for consolidated purchasing.

Example. Mr. Smith owns Companies A & B. Mr. Smith uses Company A to make all the purchases for Companies A & B. Company B reimburses Company A for the cost of purchased items, sales tax paid by Company A and a 10% purchasing agent fee.

Company A orders $100 of supplies for Company B from a Supplier. Company A pays the Supplier $108 ($100 plus $8 sales tax). The Supplier delivers the supplies to Company B. Company B, in turn, reimburses the Company A $108 and also pays a

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[17] See, e.g., Comptroller Letter No. 200209423L (Sept. 11, 2002) (determining that broadcast towers were tangible personal property where the parties' contract clearly stated that they intended the broadcast towers to be movable).

[18] 452 S.W.2d 789 (Tex. Civ. App., 1970, writ ref'd).

purchasing agent fee of $10 to Company A.

State's Challenge. State auditors are ignoring the purchasing agent relationship and imposing sales tax on Company A as though Company A were reselling the items to Company B unless there is written proof of the agency status and all vendors have been notified of this relationship.[19]

Analysis. The auditor's challenge seems to misapply the general law of agency which imposes no such requirements.

Sales Tax Consequences. If the Comptroller prevails in this position, then the group will owe sales tax on both the purchasing agent fee and the sales tax paid by the agent.

Credit for Tax Paid to Other States. Texas is a member of the Multi-State Tax Compact. As a member, Texas law allows a credit against Texas use tax for sales tax paid on the item to another state, if the other state grants Texas taxpayers reciprocal treatment.[20]

Legally Due Requirement. Texas only allows the credit if the sales tax was legally due in the other state.[21] Texas generally defers to the other state's interpretation of whether tax was legally due.[22]

Louisiana Law. Under Louisiana sales tax law, a corporation owes sales tax if the buyer arranges for shipment from Louisiana to an out-of-state location. Louisiana sales tax is not due if the Louisiana seller ships the items to an out-of-state location either using its own vehicles or by common carrier hired by the Louisiana seller.[23]

Example. A Louisiana company buys crushed rock in bulk and has the rock shipped to its location in Shreveport, Louisiana. The company pays Louisiana sales tax of 4% on the crushed rock. The company immediately uses some of the materials in Texas in performing a lump-sum contract to repair private roads to oil wells located in Texas. Texas may claim that the Louisiana company owes Texas use tax on the crushed rock unreduced by the 4% Louisiana sales tax if sales tax was not legally due in Louisiana.

Nexus. A business is "engaged in business" when it has some contact or physical connection with a taxing jurisdiction. In tax parlance, we call this "nexus."[24] Sometimes the sales tax auditors use the term "representation" instead of "nexus." Whether a taxpayer has nexus with a state determines the taxpayer's collection responsibilities in that state.

Tax-Included Contracts. In a properly drafted "tax included" contract, the buyer shifts the sales tax liability to the seller. The buyer can do this only by stating in the contract that "the stated price includes sales or use taxes."[25] This provision means that the agreed price includes the sales tax as one of its components, even though the sales tax is not separately stated.

19 See NBGS International, Inc. v. Sharp, Cause No. 97-06778; In the District Court of Travis County, Texas, 200th Judicial District.
20 Texas Tax Code § 151.303(c).
21 Comptroller Rule 3.338.
22 Comptroller Decision No. 36,403 (1997).
23 Comptroller Decision No. 36,403 (1997).
24 "Nexus" means "connection" in Latin.
25 Comptroller Rule 3.286(d)(3).

Back to Table of Contents

Strict Language Requirement. Buyers must use the specific language, verbatim as recited above in order to create a "tax included" contract. No other language will do. Other language, such as indemnifications that "all taxes due will be paid by the purchaser" is generally insufficient to create a valid tax-included contract.[26]

Texas law prohibits sellers from stating that they will absorb or refund sales taxes. Comptroller Letter No. 201101944L (01/21/2011) states that the sales tax is a transaction tax that must be collected on each sale of a taxable item. Every Texas seller must collect sales taxes on anything shipped to another resident of the state, and the amount of the sales tax must be written on the bill or the customer must receive a written notice that the amount includes the sales tax.

Sales/Use Tax Permits. Sellers must obtain a sales tax permit for each place of business in Texas. Out-of-state sellers selling items for use in Texas must obtain a use tax permit if they have sufficient nexus with Texas. Sellers are required to report monthly, quarterly or yearly depending upon the amount of tax they expect to remit.

Place of Business. A store, office or other location where you receive orders for taxable goods or services at least three times during the calendar year. A warehouse or other storage facility is not a place of business unless three or more sales are made or orders taken there during a year.

Sales and Use Tax Reports. These are generally due on the 20th day of the month following the month of sales, except for quarterly and yearly filers.

Electronic funds transfer. Taxpayers owing more than $10,000 in annual sales taxes must make payments to the Comptroller via electronic funds transfer.[27] The tax code imposes a 5% penalty for failure to use electronic funds transfer.[28]

Electronic filing. All taxpayers may now file Texas sales and use tax returns online using the Comptroller's WebFile system. Taxpayers who owe less than or equal to $100,000 per year may file electronically and pay by Discover, American Express or electronic funds transfer at:

http://www.cpa.state.tx.us/taxinfo/etf/etf.html

D. Credit for Early and Timely Payments.

Timely Payment. Sellers who pay their sales tax liability on time are entitled to a 0.5% discount on the payment.

Prepayment. Sellers may obtain a discount of 1.25% of the amount of sales tax by prepaying the tax. Monthly filers who prepay at least 90% of the entire tax by the 15th of the month for which the tax is paid (i.e., an estimated amount equal to at least 90% of what the final amount turns out to be) are entitled to an "additional" 1.25% discount on the payment.[29] We believe that the word

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[26] *See, e.g.*, Perry Homes v. Strayhorn, 108 S.W.3d 444, (Tex.App.-Austin, 2003).

[27] S.B. 640 (76th Legis. Session) amending Texas Tax Code § 111.0625. The Comptroller also plans to implement this policy for fuel tax, crude oil tax, natural gas tax, and International Fuel Tax Agreement (IFTA) reports.

[28] Texas Tax Code § 111.063.

[29] Comptroller Rule 3.335.

"additional" means that you would also be entitled to the 0.5% timely payment discount. Quarterly filers who pay at least 90% of the final liability by the 15th day of the second month of the quarter are also entitled to the 1.25% discount.

Record Retention Guidelines. Sales records must be kept for four years. This applies to all sellers, users/consumers of taxable items and taxable service providers.

Direct Pay Permits. Purchasers who buy at least $800,000 of taxable items for their own use may apply for a permit that allows the purchaser to pay sales tax on the purchased items directly to the Comptroller. This is in lieu of having the seller of items collect the sales tax from the purchaser and remit it to the Comptroller.

A searchable listing of direct payment permit holders is available on the Comptroller's web site at:

http://aixtcp.cpa.state.tx.us/dirpay/dir_pay_srch.php.

E. Oil and Gas Well Servicing Tax.

Texas law imposes an occupation tax on anyone in the business of providing certain well services, and who:

- owns, controls, or furnishes the tools, instruments, and equipment used in providing well service; or
- uses any chemical, electrical, or mechanical process in providing service at any oil or gas well during the drilling and completion, or reworking or reconditioning, of the oil or gas well.[30]

[30] Texas Tax Code §§ 191.081 *et seq.*

The oil and gas well servicing tax applies after a site has been developed and a hole has been drilled. Taxable services under the oil and gas well servicing tax are generally designed to stimulate production of an oil or gas well. It's important to distinguish which services are subject to Texas sales and use tax, which ones are subject to oil and gas well servicing tax, and which ones are nontaxable. The tax collection and/or payment responsibilities vary with each. These distinctions are discussed further in Chapter II of these materials.

Taxable oil and gas well services include:

- Cementing the casing seat
- Shooting the formation
- Fracturing the formation
- Acidizing the formation
- Surveying or testing the formation

The tax is imposed at the rate of 2.42% of fees for taxable services. Reports are due monthly on the 20th day of the month following the end of each calendar month. The service provider does not collect the tax from its customers but pays the tax based on its receipts from well services provided for consideration.

Example. Well Service Company ("WSC") provides cementing, shooting, fracturing, acidizing and surveying services to the oil and gas industry. WSC must pay tax on the fees it receives for its services. Unlike the sales tax, WSC may not collect the tax from its customers but must pay the tax on the gross amount received for the service after deducting the reasonable value at the well of material used, consumed, expended in or incorporated in the well.

Back to Table of Contents

WSC may pass the cost along to its customers; however, if it does, the reimbursements are considered part of the taxable well service fee receipts.[31]

Example. WSC also has a division which operates wells for various oil and gas companies. WSC and the well operating division are part of the same legal entity. Sometimes the well operating division will become a partner in an oil or gas well and WSC will issue an inter-company invoice, for accounting purposes, to document the inter-company transaction. In this case, WSC is not required to pay the well servicing tax because it is providing services for itself – it is not providing well services to third parties for consideration.[32]

F. Oil and Gas Production / Severance Taxes.

Texas law imposes oil and gas production taxes, or severance taxes on the market value of oil and gas at the wellhead. Various requirements and exemptions apply, which Chapter III and Chapter IV will discuss in greater detail.

Crude Oil Production Tax. Texas imposes a 4.6% tax on the production of crude oil in Texas at its market value at the wellhead. The market value at the wellhead is the market value of the oil, plus any bonus or premium, and less any physical transportation costs. The tax is imposed at various rates depending on the circumstances. The Comptroller has a feature on her website for searching for crude oil and natural gas taxpayers:

https://ecpa.cpa.state.tx.us/cong/taxpayerSearchForward.do;jsessionid=0000nPIpSypO0okhndCNgAMMReE:-1.

Example. Crude Bob incurs direct and indirect post-production costs in connection with the sale of crude oil. Bob incurs these costs after the production process and before the ultimate sale of the oil.

Crude oil is taxed based on the market value of oil produced in this state. The market value at the wellhead does not take into account any post-production costs. The market value of oil is defined to mean, "...the actual market value plus any bonus, premium, or other thing of value paid for the oil or that the oil will reasonably bring if lawfully produced."

The only post-production cost allowed as a deduction for crude oil tax is a charge for physical trucking incurred by the producer in those instances where it is necessary for the producer to truck his oil to a point where a purchaser will take the oil. Unless the costs qualify as physical trucking, they may not be deducted from the market value of the oil for purposes of calculating the crude oil production / severance tax.[33]

Natural Gas Severance Tax. Texas law requires natural gas producers to pay a tax based on the market value at the wellhead of gas produced and saved in the state. "Production" or "gas produced" means the gross amount of gas taken from the earth or water.

Producers determine the quantity based on meter readings expressed in cubic feet.[34] The tax rate for gas production is 7.5% of the market value

31 See Comptroller Letter No. 200106297L.
32 See Comptroller Letter No. 200106297L.
33 See Comptroller Letter No. 9804761L.
34 Texas Tax Code § 201.001 (6).

of the gas produced. The rate for condensate production is 4.6% of market value. Condensate is liquid hydrocarbon that is or can be recovered from gas by a separator, but does not include liquid hydrocarbon recovered from gas by refrigeration or absorption and separated by a fractionating process.[35]

Producers must also pay a regulatory fee. For report periods prior to September 2001, the rate was 1/30 of a cent (.000333) for thousand cubic feet of gas produced. For report periods September 2001 and later, the rate is .000667 for thousand cubic feet of gas produced. The reports must be filed by 20th day of the 2nd month following the production month. Certain qualified taxpayers may file an annual report, which is due by February 20th for the preceding year.

Reduced gas production tax rates are available for certified exemptions, including the Incremental Production Exemption (3.75% of market value of gas); 3 Year and 2 Year Inactive Well Exemptions (0% of market value of gas); Co-Production Project Exemption (0% of market value of gas); High-Cost Gas Exemption (0% of market value of gas); High-Cost Gas Reduced Tax Rate (0% to 7.4% of the market value of gas) and Flared Gas Exemption (0% of market value of gas). The Texas Experimental Research and Recovery Activity (TERRA) Exemption (0% of market value of gas) was repealed by the 2003 legislature.

The rate varies by well depending on how the well's drilling and completion costs compare to the median cost of all High-Cost gas wells during the previous State fiscal year. A calculation tool for estimating the reduction in tax is located on the Comptroller's website at

http://ourcpa.cpa.state.tx.us/ngrate/wellcalc.html.

Marketing Costs. Gas producers determine the taxable "market value at the month of the well" by subtracting the producer's actual marketing costs from the producer's gross cash receipts from the sale of the gas. Marketing costs are costs the producer incurs to move the gas from the mouth of the well to the market.

Gas marketing costs include costs for:

- compressing the gas sold;
- dehydrating the gas sold;
- sweetening the gas sold; and
- delivering the gas to the purchaser.

Marketing costs do not include:

- costs incurred in producing the gas;
- costs incurred in normal lease separation of the oil or condensate; and
- insurance premiums on the marketing facility.

A producer shall determine the deductible marketing costs by adding together the following:

- Facility charges. A reasonable charge for depreciation of the marketing facility being utilized. If the facility is rented, the actual rental fee shall be used.
- Return on investment. A return on the producer-owned investment equal to 6% per annum on the average depreciable balance.

[35] Texas Tax Code § 201.001(2).

Back to Table of Contents

- Labor. Direct or allocated labor associated with the marketing facility.
- Materials, supplies, maintenance, repairs, and fuel associated with the marketing facility.
- Taxes. Ad valorem taxes paid on the marketing facility.

Cost Allocation. If the facility is used for purposes other than marketing the gas being sold, then the cost shall be allocated accordingly. If the facility is handling gas for outside parties, then the average cost for handling all of the gas shall be applied against the facility owner's gas. Outside parties' actual charges for marketing functions may be used for tax purposes provided no other benefit or value accrues to the producers.

Reimbursements. Producers who receive cost reimbursements from gas purchasers include the reimbursements in the gross cash receipts and deduct the actual marketing cost incurred.

Example. ABC Petroleum is a gas producer. ABC incurs marketing costs in moving the gas from the wellhead to the purchaser's pipeline. ABC uses compressors to move the gas through its own pipeline to the purchaser's pipeline. ABC owns the pipeline and rents the compressors. It incurs marketing costs of depreciating the pipeline and renting the compressors. It may deduct these marketing costs from the price received to determine how much severance tax is due.

G. Fuel Taxes and Fees.

Texas law imposes fuel taxes and fees on the sale of finished petroleum products. Oil and gas producers and service providers frequently encounter fuel tax issues in transporting equipment and product to and from the well site.

Diesel Fuels Tax. Texas law imposes a diesel fuels tax on:

- The net gallons of diesel fuel removed from the terminal rack or imported into this state, other than in the bulk transfer/terminal system.
- The net gallons of diesel fuel sold to an unlicensed purchaser within the bulk transfer/terminal system.
- The gallons of diesel fuel blended in this state outside the bulk transfer/terminal system.
- The gallons of diesel fuel brought into this state in the fuel supply tanks of a commercial motor vehicle licensed as an interstate trucker, or an IFTA licensed vehicle.[36]

The tax is imposed at a rate of 20¢ per gallon on diesel fuel removed from a terminal, imported, blended, sold to an unauthorized person, or otherwise used in a taxable manner and not exempted by statute.[37]

Different filing deadlines apply to the parties producing, marketing and selling and using diesel fuels: Suppliers, permissive suppliers, distributors, importers, exporters, and blenders file reports monthly on the 25th day of the month following the end of the calendar month. Suppliers and importers may deduct 2% for timely payment of the tax.[38] Distributors and importers may deduct 1.75% for timely payment.[39]

36 Texas Tax Code § 162.201.
37 Texas Tax Code § 162.202.
38 Texas Tax Code §§ 162,217 and 162.220.
39 Texas Tax Code § 162.214.

Back to Table of Contents

Dyed Diesel Fuel Bonded Users and interstate truckers (except IFTA licensed truckers) file reports quarterly on the 25th day of the month following the end of the calendar quarter. Some qualifying taxpayers may report the tax annually by January 25 of the year following the taxable fuel use.[40]

IFTA licensees file reports quarterly on the last day of the month following the end of the calendar quarter.[41]

Taxpayers may search for licensed persons at:

- **http://aixtcp.cpa.state.tx.us/fuelperm.html,**
- **http://aixtcp.cpa.state.tx.us/newperm.html and**
- **http://ourcpa.cpa.state.tx.us/fuels/FuelsSearch.jsp.**

Gasoline Tax. Texas law imposes a gasoline tax on:

- The net gallons of gasoline removed from the terminal rack or imported into this state, other than in the bulk transfer/terminal system.
- The net gallons of gasoline sold to an unlicensed purchaser within the bulk transfer/terminal system.
- The gallons of gasoline blended in this state outside the bulk transfer/terminal system.
- The gallons of gasoline brought into this state in the fuel supply tanks of a commercial motor vehicle licensed as an interstate trucker, or an IFTA licensed vehicle.[42]

The tax is imposed at a rate of 20¢ per gallon on gasoline removed from a terminal, imported, blended, sold to an unauthorized person, or otherwise used in a taxable manner and not exempted by statute.[43] Different filing deadlines apply to the parties producing, marketing and selling and using gasoline: Suppliers, permissive suppliers, distributors, importers, exporters, and blenders - monthly: 25th day of the month following the end of the calendar month. Suppliers and importers may deduct 2% for timely payment of the tax.[44] Distributors and importers may deduct 1.75% for timely payment.[45]

Interstate truckers (except IFTA licensed) pay quarterly on the 25th day of the month following the end of the calendar quarter; or yearly, if qualified, on January 25.

IFTA licensees pay quarterly on the last day of the month following the end of the calendar quarter.[46]

Fuel Tax Refund for Volunteer Fire Departments. Texas volunteer fire departments may purchase gasoline and diesel fuel free from state tax in bulk from license holders for the department's exclusive use in motor vehicles and equipment owned or leased and operated by the department.[47]

Volunteer fire departments continue to owe state motor fuel taxes when buying gasoline and diesel fuel at retail service stations and may claim a refund of those taxes from the Comptroller for purchases made on or after July 1, 2009. License holders who have paid tax on their purchase of gasoline or diesel fuel

40 Texas Tax Code § 162.215.
41 *See* IFTA Articles of Agreement – R960.
42 Texas Tax Code §162.101.
43 Texas Tax Code § 162.102.
44 Texas Tax Code §§ 162,116 and 162.119.
45 Texas Tax Code § 162.113.
46 IFTA Articles of Agreement - R960.
47 Senate Bill 254 (Effective July 1, 2009).

and subsequently resell the gasoline or diesel fuel to a Texas volunteer fire department without collecting the tax on or after July 1, 2009, may claim credits on their monthly tax returns.

Liquefied Gas Tax. Texas law imposes a tax on the use of liquefied gas (i.e., butane, propane, compressed natural gas) as a motor fuel. Motor vehicles licensed in Texas and equipped with liquefied gas systems are required to prepay the tax by purchasing a liquefied gas tax decal. Motor vehicles licensed in other states, Mexico, or licensed under the IFTA pay the tax at the retail pump to a licensed dealer.[48]

Licensed dealers and interstate truckers (except IFTA licensed dealers) pay the tax annually at a rate of 15 cents per gallon by January 25 for previous year.[49] Taxpayers may pre-pay the tax. Prepaid users pay the tax based on the mileage and registered gross weight of the vehicle. The tax is due 15 days prior to the registration anniversary.[50] Dealers may apply timely filing discounts of 1% and interstate truckers may apply discounts of ½% for timely filing the liquefied gas tax reports.[51]

Texas Emissions Reduction Program (TERP) Surcharge. Texas law imposes a surcharge on the sale, use, lease or rental of off-road, heavy-duty diesel equipment and is based on the sale, lease or rental amount. The surcharge is 2% of the sales or lease price of certain equipment. Reports are due monthly, quarterly or annually, based on the level of activity. The tax is due by the 20th of the month following the end of the taxable period.[52]

In 2003, the legislature increased the Texas emissions reduction plan surcharge on sales of off-road, heavy-duty diesel equipment from 1% to 2%.53 Effective July 1, 2003, the surcharge applies not only to construction equipment but also to other off-road, heavy-duty diesel equipment, including but not limited to the following:

- Mining equipment;
- Oil or gas exploration and production equipment;
- Rock and gravel crushers;
- Forklifts;
- Cement mixers;
- Tractors; and
- Motorized cranes.

Effective September 1, 2005, the surcharge does not apply to recreational vehicles that are not held or used in the production of income.[54]

Automotive Oil Sales Fee. Texas law imposes a fee on the first sale of automotive oil delivered to a location in Texas and sold to a purchaser who is not an automotive oil manufacturer or distributor; and on automotive oil imported into Texas for sale, use, or consumption. The fee is imposed on oil manufacturers, distributors, and importers at the rate of one cent per quart of automotive oil imported or sold in Texas. Automotive oil sales fee reports are due quarterly by the 25th day

48 See Texas Tax Code §§ 162.301 and 162.305.
49 Texas Tax Code § 162.308.
50 Texas Tax Code § 162.305.
51 Texas Tax Code §§ 162,308.

52 Texas Tax Code § 151.0515.
53 H.B. 1365 (78th Legis. Session) (amending Texas Tax Code § 151.0515).
54 Senate Bill 867, amending Texas Tax Code § 151.0515. A recreational vehicle is defined as a motor vehicle primarily designed as temporary living quarters for recreational camping or travel.

Back to Table of Contents

of the month following the end of each calendar quarter.

Petroleum Products Delivery Fee. Texas law imposes a petroleum products delivery fee, which is collected by bulk facility operators (rail, pipeline, barge, or refinery terminals) upon the withdrawal of petroleum products into cargo tanks and on petroleum products imported into Texas. The fee varies according to the net total gallons of all petroleum products withdrawn. Reports are due monthly on the 25th day of the month following the end of each calendar month.[55]

Changes effective July 1, 2012. The Texas legislature reauthorized and made permanent the petroleum products delivery fee, which had been set to expire on Aug. 31, 2011.[56] The law requires the Texas Commission on Environmental Quality (TCEQ) to set, by rule, the petroleum product delivery fee rates. The fee applies to all petroleum products imported into Texas or withdrawn from a Texas bulk storage facility and delivered into cargo tanks or barges.

The TCEQ fee is based upon total net gallons delivered, as shown in this schedule, beginning July 1, 2012:

Net Gallons Delivered	Fee
< 2,500	$ 2.75
≥ 2,500 but < 5,000	$ 5.50
≥ 5,000 but < 8,000	$ 8.65
≥ 8,000 but < 10,000	$11.00
≥ 10,000 per 5,000 or increment thereof	$ 5.50

For gasoline deliveries of at least 7,000 but less than 8,000 net gallons (whether single product type or split load), special rules apply:

- If the gasoline portion of the delivery is less than 7,000 net gallons, the fee is $8.65.
- If the gasoline portion of the delivery is at least 7,000 net gallons, the total load is presumed to be at least 8,000 gallons and the fee is $11.00.[57]

Coastal Protection Fee. Texas law imposes a coastal protection fee on all crude oil and condensate transferred from or to vessels at a marine terminal located in Texas. The tax is imposed at the rate of 2¢ per barrel of crude oil or condensate. The rate can vary or the fee can be suspended, depending on the balance in the Coastal Protection Fund. The Comptroller may suspend the fee when the unobligated balance in the fund reaches $25 million.

International Fuels Tax Agreement (IFTA). In discussing oil and gas taxes and motor fuels taxes it's important to know about IFTA. IFTA is not a separate tax or fee. It's an agreement that provides for the consolidated reporting of motor fuels (i.e., Gasoline, Diesel Fuel, Liquefied Gas) taxes for qualifying commercial motor vehicles traveling in more than one state or province of Canada. Each of the member jurisdictions set the applicable tax rates. Interstate carriers based in Texas report fuel tax paid in all member jurisdictions. The reports are due

55 Texas Water Code § 26.3574. S.B. 1863 (2005 Texas Legislature) continues the petroleum products delivery fee at its current rate. The fee will expire on September 1, 2007.
56 House Bill 2694, passed during the 82nd Legislature Regular Session (2011).

57 Tax Policy News, May 2012.

Back to Table of Contents

quarterly on the last day of the month following the end of each calendar quarter.[58]

Example. Trucks 'R Us dispatches trucks and trailers to various locations within the United States. Trucks 'R Us has elected Texas as its "base state" for purposes of reporting motor fuel taxes. Under the IFTA multi-state tax agreement, Trucks 'R Us will report to Texas its fuel tax paid and used throughout the United States. The various states, however, may provide separate motor fuels tax exemptions. Trucks 'R Us would report any exempt fuel use to each particular state in order to claim a tax credit against the tax paid under IFTA. The exemption requirements and the statutes of limitations for claiming refunds may vary from state to state.

Motor Fuels Transporter Licenses. Texas law requires sole owners, partnerships, corporations, or other organizations transporting gasoline or diesel fuel in this state by truck, railroad tank car or marine vessel to be licensed with the Comptroller's Office. The license requirement applies to motor fuels transporters who transport fuel outside the bulk transfer/terminal system.[59] Persons transporting their own fuel in their own cargo tanks for their own use and not for resale are not required to obtain a motor fuel transporter license. Motor fuel transporters must file informational reports quarterly by the 25th day of the month following the end of the calendar quarter.[60] The informational reports disclose the transporters' interstate and intrastate transportation of gasoline and diesel fuel during the previous quarter.[61]

H. Electronic Funds Transfer.

Beginning May 1, 2008, taxpayers are required to make mandatory payments by electronic funds transfer it they paid $10,000 or more in a payment category during the preceding state fiscal year.[62] The threshold was lowered from $100,000 to $10,000 in 2007 for:

- Sales & Use Tax;
- Direct Pay Permit Holders;
- Natural Gas;
- Crude Oil;
- Franchise;
- Gasoline;
- Diesel Fuel;
- Hotel Occupancy;
- Insurance Premium;
- Mixed Beverage Gross Receipts; and
- Motor Vehicle Rental.

The Comptroller's office should inform taxpayers at least 60 days prior to the due date if they meet the mandatory electronic funds transfer requirements. Taxpayers remitting less than $100,000 of Sales & Use Tax can make electronic payments by credit card or WebEFT via WebFile. They can also pay electronically via internet or telephone if they enroll in TEXNET.[63]

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58 More information is available on the International Fuels Tax Association, Inc. website at: http://www.iftach.org/index4.htm.

59 Texas Tax Code § 162.001.

60 Texas Tax Code §§ 162.114 and Sec. 162.215.

61 Texas Tax Code §§ 162.121 and 162.222.

62 81st Legislature 2007, R.S., S.B. 377.

63 *See* Comptroller's website: http://www.window.state.tx.us/taxinfo/etf/eft.html.

I. Late Filing Penalties.

The Texas legislature enacted a $50 penalty for certain taxpayers who file their tax reports late.[64] The penalty applies to the following tax types affecting the oil and gas industry:

- franchise tax;
- motor fuels tax;
- sales and use tax (including direct pay); and
- the off-road, heavy-duty diesel equipment surcharge tax.

The penalty applies to reports filed late, beginning with reports originally due on or after Oct. 1, 2011, and is due in addition to any other penalties assessed for a reporting period. It is due regardless of whether the taxpayer later files the report or whether any taxes or fees were due.

A person who doesn't receive or obtain the correct report form from the Comptroller's office is not relieved of the responsibility to file a report and remit the required tax or fee.[65]

J. Tax Clearance Letters.

The Business Organizations Code now requires all taxable entities to provide a certificate or "tax clearance letter" issued by the Comptroller when filing for withdrawal, conversion, reinstatement, termination or dissolution with the Texas Secretary of State.[66]

K. Prepayment for August 2013.

The Texas legislature enacted budgetary measures that require a tax prepayment of 25% of the tax for gasoline or diesel fuel removed at the terminal rack during the month of July 2013. The payment is due on or before Aug. 28, 2013 from each licensed distributor and licensed importer is required to remit to the licensed supplier or licensed permissive supplier, as applicable.

Suppliers and permissive suppliers must also pay the tax received from distributors and importers, and tax due on their own removals from the terminal, to the Comptroller's office by electronic funds transfer (EFT) on or before Aug. 30, 2013.[67] The supplier's tax prepayment equals 25% of the tax on gasoline or diesel fuel removed from a terminal for distribution in Texas. The permissive supplier's prepayment equals 25% of the tax on gasoline or diesel fuel removed from its inventory in an out-of-state terminal for delivery into Texas.

In making the prepayment, the distributor, importer, supplier or permissive supplier does not receive any credit or allowance to which it is normally entitled. Taxpayers submitting prepayments may, however, take credits on their August reports (due in September) equal to the prepayment amount. At that time, the taxpayers may also take any credits or allowances to which they are normally entitled.

[64] Senate Bill 1, 82nd Legislature, 1st Called Session, Article 14 (Effective Oct. 1, 2011).
[65] Tax Policy News, May 2012.
[66] Senate Bill 1442 (Effective Sept. 1, 2009).
[67] Senate Bill 1, 82nd Legislature, 1st Called Session, Article 9 (Effective Oct. 1, 2011).

Back to Table of Contents

Chapter II. Taxable Services

A. Introduction

Oil and gas well services may be taxable under either the sales and use tax laws[68] or the oil well service tax statute.[69] Certain categories of oil and gas well services are not taxable at all.

It's important to understand which services fall into which categories. Taxable service providers are required to collect sales tax from their customers but may purchase items under a resale exemption if they transfer care, custody and control of the items to their customers. In contrast, providers of non-taxable services must pay tax on all of their purchases, including items transferred, equipment and supplies. Moreover, service providers that are subject to the oil and gas well servicing tax do not collect the tax from their customers but pay the tax based on receipts from well services.

Taxable Services. Services are only subject to sales tax if they are included on the statute's list of taxable services.[70]

The following services are taxable:

- Amusement Services
- Cable Television Services
- Personal Services
- Motor Vehicle Parking and Storage
- Repair, remodeling, maintenance and restoration of tangible personal property (October 2, 1984), except:
    - aircraft;
    - water transportation vessels (except certain pleasure vessels);
    - repair, maintenance and restoration of a motor vehicle; and
    - repairing, maintaining, creating or restoring a computer program, sold by someone other than the person performing the repair, maintenance, creation or restoration (including software development and modification).
- Telecommunication services
- Credit reporting services
- Debt collection services
- Insurance services
- Information services
- Real property services
- Data processing services
- Security services
- Real property repair and remodeling
- Telephone answering services
- Internet Access Services

These materials will focus on those services which most commonly affect the oil and gas industry.

B. Information Services.

Oil and gas producers may purchase information services to track market prices of fuel or other pertinent data. Texas tax law exempts 20% of the charge for information services and data processing services incurred after October 1, 1999.[71]

68 The official name is: The Texas Limited Sales, Excise and Use Tax and is found in Texas Tax Code §§ 151.001 et seq.

69 See Texas Tax Code §§ 191.081 et seq.

70 See Texas Tax Code § 151.0101.

71 Texas Tax Code § 151.351.

Back to Table of Contents

"Information services" means:

- furnishing general or specialized news or other current information, including financial information, unless furnished to a newspaper or to a radio or television station licensed by the FCC; or
- electronic data retrieval or research.[72]

"Taxable information service". This is information which is gathered, maintained or compiled and made available by the provider of the information service to the public or to a specific segment of industry for a fee.

Examples of such information include:

- Internet Service Providers (ISPs);
- newsletters;
- websites;
- scouting reports and surveys (including those used in sports and the oil and gas and related industries);
- mailing lists;
- bad check lists;
- real estate listings;
- financial, investment, stock market or bond rating reports; and
- news clipping services, wire services and title abstracts.

Providing access to information (databases maintained by the seller of the service) on the Internet is a taxable information service. For example, the Comptroller has taken the position that a service which provides information to the oil and gas industry regarding the availability of underground storage (such as salt dome reservoirs, abandoned salt mines and aquifers) is a taxable information service.[73]

"Non-taxable Information Services." This includes:

- information which is gathered or compiled on behalf of a particular client if the information is of a proprietary nature and may not be sold to anyone else (i.e., opinion polls and management consultant reports);
- information derived from laboratory, medical or exploratory testing or experimentation or any similar method of direct scientific observation of physical phenomena (i.e., geological surveys and medical test results);
- information required to be furnished pursuant to the Open Records Act; and
- information furnished to a member of a homeowners' association by or on behalf of the association.

C. Real Property Services.

The Texas Tax Code imposes sales and use tax on certain listed real property services. These services are taxable regardless of whether they are performed on commercial or residential property.[74] Taxable real property services include:

- Landscaping
- Lawn Maintenance
- Garbage Removal
- Janitorial Services
- Pest Control

72 Comptroller Rule 3.342.

73 See Comptroller Letter No. 9604L1407D01 (Gilbert Zamora, April 3, 1996).

74 Texas Tax Code Sec. 151.0048.

Back to Table of Contents

- Surveying Services

Taxable garbage removal includes the removal or collection of garbage rubbish or other solid waste other than:

- Hazardous waste, as identified or listed as a hazardous waste by the administrator of the United States Environmental Protection Agency or by other appropriate federal or state agency;
- Industrial solid waste, as that term is defined in Health and Safety Code, Chapter 361, with the exception of industrial solid waste which meets the definition of garbage or municipal solid waste;
- Waste material associated with exploration, development, or production activities for oil, gas, geothermal resources, or other substances or materials regulated by the Texas Railroad Commission (RRC);[75]
- Domestic sewage or an irrigation return flow (to the extent the sewage or return flow doesn't constitute "garbage" or "rubbish"); and
- Industrial discharges regulated by permit.[76]

The exclusion for removal or collection of waste material resulting from activities associated with the exploration, development, or production applies to oil, gas, geothermal resources, or any other substance or material regulated by the RRC.[77] For example, collecting and disposing of used and depleted drilling mud, drilling fluids, saltwater, broken pipe or other waste directly coming from an oil or gas well is not a taxable service when provided during the exploration, development and production of an oil or gas well.[78]

The invoice and contract between service provider and customer must clearly state that the waste removal service is for waste created from the exploration, development and production of an oil or gas well or substances regulated by the RRC. An exemption certificate is not required. However, a waste disposal service operator providing the service may request an exemption certificate from the purchaser of the service as additional documentation that the sale qualified for exclusion from tax.

The collection and removal of any other waste that does not directly result from the exploration, development or production of an oil or gas well is taxable.

Examples. Empty food and beverage containers, wrappers, bags and other unwanted personal disposal items.

It doesn't matter that the waste was generated by the well service staff, roustabouts, roughnecks, operator or others. Collecting and removing personal disposal items is a taxable real property service.

D. Landmen Services.

Petroleum landmen negotiate trades and deals with other companies and individuals, draft contracts and administer compliance with them, acquire leases and ensure compliance

75 Natural Resources Code Sec. 91.101.
76 Texas Water Code, Chapter 26.
77 *See* Natural Resources Code § 91.101.
78 Tax Policy News, May 2012. *See* Tax Code § 151.0048(a)(3)(C).

with governmental regulations.[79] They also research courthouse records to determine ownership, prepare necessary reports, locate mineral owners and land owners, negotiate oil and gas leases and various other agreements with landowners, obtain necessary curative documents, and conduct pre-drilling surface inspections.

The Comptroller considers landmen services to be nontaxable professional services, even though they may incidentally include some taxable services necessary for performing the nontaxable service. The service provider should therefore pay tax on any taxable purchases of tangible personal property and taxable services used by the landman to perform his work (e.g., real property services, information services, data processing, etc.). If a landman subcontracts taxable services from another landman on a stand-alone basis, those services will be still be taxable. However, landman services themselves are nontaxable to the customer, regardless of whether the billing method is lump sum or separated.[80] A landman is not required to obtain a sales and use tax permit unless he will perform stand-alone taxable services.[81]

Example. A landman subcontracts the services of fixing title defects, including running sheets of title and metes and bound information for surveyors. To the extent these services are taxable on a stand-alone basis, the landman must pay tax on the purchase of the services. The Comptroller considers running sheets of title and providing metes and bounds information to be taxable services. Therefore, the landman would be considered the consumer of those taxable services and would be required to pay tax to the subcontractor on those services but would not charge tax to the ultimate consumer of the landman services. No resale exemption applies, since the landman is considered the consumer.[82]

Example. A landman's customer is a direct pay permit holder. However, the landman cannot use the direct pay permit holder's certificate to make purchases tax-free, even if the purchases are made in connection with the work the landman is performing for the direct pay permit holder.[83]

E. Drilling/Workover/Repair.

Services performed as part of drilling or workover are generally not taxable. However, services performed during a routine repair are taxable. Services performed during the original drilling of a well or the workover of a well that has stopped producing or reduced production are not taxable.

Workover includes remedial operations when the formation has declined in production or ceased to produce, with the hope of restoring or increasing production:

- Deepening a well or plugging back

[79] *See* Comptroller Letter No. 200809178L (citing American Association of Professional Landmen).

[80] *See* Comptroller Letter No. 200703984L. The Comptroller looks to the essence of the service, regardless of whether the portion of those services that would normally be taxable exceeds 5%.

[81] *See* Comptroller Letter No. 200809178L. Question 6.

[82] *See* Comptroller Letter No. 200809178L. Questions 1-4.

[83] *See* Comptroller Letter No. 200809178L. Question 5.

- Clearing well of deposits
- Correcting problems
- Cleaning

Drilling Oil and Gas Wells. In general, the labor performed in drilling a new oil and gas well is not subject to either the sales and use tax or the oil well servicing tax. This includes the labor for site preparation and the labor of the various crews that drill well. The primary sales tax issue arising in drilling an oil and gas well concerns whether the charge is for the sale of tangible personal property or whether the charge is for the performance of non-taxable new construction.

Example. Building New Locations. Generally speaking drilling a new well (building a new location) is new construction. The labor charge for new construction is not taxed. Of course, tax is due on the materials and other taxable items used to perform the work. The person responsible for paying the tax on the incorporated materials is determined by the contract.[84]

Example. A Comptroller hearing decision considered the issue of when the installation of pipe is nontaxable new construction, rather than a taxable repair to commercial real estate.[85] The ALJ determined the pipeline company could purchase labor tax-free to install new replacement pipe where the pipeline trenches were first lowered from a depth of 20 inches to a depth of 30 inches. The increased depth was required to comply with federal regulations and to allow room for sandbags to be placed under the pipelines to protect the pipe coating.

Repairs. Repairs to tangible personal property are generally taxable. In addition, repairs made to real property in connection producing oil or gas is taxable. Repairs include activities such as replacing worn, corroded, or broken parts.

Fishing Services. Well fishing services are not taxable when performed during activities such as starting initial production or workover.[86]

Example. *Davis-Kemp Tool Co., Inc. v. Bullock*,[87] considered whether a taxpayer was entitled to a resale exemption for renting fishing tools used in performing fishing services. Davis-Kemp rented the tools from a third party and then used them to perform fishing services for its customers. Davis-Kemp rebilled the tool rental charge, along with labor costs and transportation charges, to its customers. The court determined that Davis-Kemp was not entitled to claim a resale exemption on its lease of the equipment since Davis-Kemp's customers never obtained any control or dominion over the equipment.[88]

Davis-Kemp, not the customer, was the consumer of the equipment rental because the customer never had any control over the equipment or the taxpayer's personnel operating the equipment on the job site.[89]

84 Comptroller Letter No. 9410L1329G03.
85 Comptroller Hearing No. 44,134 (February 24, 2005).
86 Comptroller's Letter No. 200002026L.
87 584 S.W.2d 579 (Tex. App. – Beaumont 1979, reh'g denied)
88 *Id.* at 580.
89 *Id.* at 581.

F. New Construction.

"New construction," as contrasted with "repair and remodeling," is not a taxable service. In the oil and gas industry, drilling a new well (building a new location) is generally new construction. The labor charge for new construction is not taxed. However, tax is due on the materials and other taxable items used to perform the work. The contract determines who is responsible for paying the tax on the incorporated materials.[90]

Caution. A Comptroller hearing decision determined that replacing an oil and gas storage tank's floating roof with a new cone roof was not new construction even though it added cubic footage to the tank.[91]

Welding. The Comptroller assumes that all welding in the field is taxable unless the welder's billings clearly indicate that the work was performed by a third-party installer. Charges for welding are taxable when it's fabrication labor or part of a repair or remodel job. Welding pipe into different configurations is taxable remodeling labor.[92] Pipe priming, coating, and wrapping are taxable as processing.[93]

Board Road Rentals. Sales tax is due on the rental of board roads and board turn-around areas. Board roads are temporary roadways constructed of wooden planks in marsh areas such as oil field leases. The Comptroller's position is that the labor charges for assembling board roads and turn-around areas in oilfields are taxable fabrication labor rather than non-taxable installation labor. They are taxable even if separately stated by a third party.[94]

G. Processed Materials.

Sales of processed materials are subject to the sales tax. Processed materials include stone that has been crushed and materials that are mixed such as spud mud or ready mix concrete. Rock that has been blasted out of the earth or a hillside is considered processed.[95]

Sand, Dirt and Gravel. Sand, dirt, gravel and similar materials are used to prepare the drill site prior to drilling. These materials are subject to sales tax if they are sold in processed form. However, persons who furnish, sell, or deliver unprocessed sand, dirt, and gravel are providing a nontaxable service.[96] Materials that are only washed or sorted are considered unprocessed and therefore non-taxable.

Drilling Mud. Drilling mud or drilling fluid is used primarily to circulate out cuttings, to maintain downhole pressure and to provide cooling for the drill bit during the drilling of an oil or gas well. The Comptroller considers the sale of drilling mud taxable.

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[90] *See, e.g.*, Comptroller Letter No. 9410L1329G03 (October 6, 1994).
[91] Comptroller Decision No. 38,069 (December 15, 1999).
[92] *See, e.g.*, Delta Pipe Fabricators v. Bullock, 638 S.W.2d 652, Tex. App – Austin (1982).
[93] Comptroller Letter No. 9111T1141A07 (November 8, 1991).
[94] See Hearing No. 23,333 Prior to 10/1/87 installation labor was nontaxable if separately stated.
[95] Effective October 14, 1988 the blasting company may purchase the explosives used to break up the rock tax free under Comptroller Rule 3.300.
[96] Effective June 13, 1988.

Drilling Mud Additives. Drilling mud additives may or may not be taxable. If the additive is crude oil, (unrefined liquid petroleum,) then it is not subject to sales tax. If the additive is a refined petroleum product, it is taxable.

Example. Rock (rip-rap), limestone, caliche and chipped rock are used in the oil and gas industry for construction of lease roads to the drilling location. Their purpose is to stabilize the soil and create an all-weather access. Screening or washing the materials is not considered processing. However, crushing the material is considered processing. The rip-rap, limestone and caliche are not taxable if they are sold in the condition that they are found in nature. These materials are taxable if they are crushed or mixed. The chipped rock is taxable because it has been processed.[97]

Example. Hauling Caliche. The charge for hauling caliche may be part of the sales price of the nonresidential repair service and taxed. The charge for hauling alone (not connected with a taxable sale) is not taxed.[98]

H. Services Performed on Wells.

Services Performed on the Formation. In general, if the company performs services on the oil and gas producing formation itself (for example: fracturing the formation to enhance the flow of oil), the charges are not subject to the sales and use tax laws. They are taxable under the oil well servicing tax. We cover this tax later in this chapter.

[97] Comptroller Letter No. 8809T0895B04 (Eddie C. Washington, August 20, 1988).
[98] Comptroller Letter No. 9410L1329G03.

Services Performed on Well Equipment, in the Casing, or at the Site. If the service is performed on the well equipment, inside the casing of the well, or on the well site grounds, the activity may be taxable under the sales and use tax laws. The sales and use tax applies to well servicing activities that fall within the repair and remodeling rules for real and personal property and within the real property services rules.

Well Equipment. Charges for labor to repair, restore, remodel, or maintain tangible personal property, such as well equipment, became taxable on October 2, 1984.

For example, repairing, restoring, remodeling or maintaining any of the following equipment[99] is taxable:

- Christmas trees, wellhead and well components, including line heaters;
- Storage facilities (tanks or batteries) each with a storage capacity of 500 barrels or less;
- Gathering lines and flow lines which are above the ground;
- Gathering lines and flow lines which are buried;[100]
- Wellhead pumping equipment, pumpjacks and their power source;
- The rig or production package attached to offshore platforms;
- Electric power systems which are easily removed;
- Compressors which are easily moveable and located in the field (between the wellhead and booster stations);

[99] The Comptroller's auditor's sales tax manual states that the Comptroller considers these items to be tangible personal property.
[100] Or partially buried (as of July 1, 1985).

- Board roads and board turnaround areas;
- Everything inside the casing of a well. This includes, but is not limited to, tubing, pipe, pumps, rods, gas-lift equipment, and packers inside the casing.

Downhole Services Subject to Sales Tax. Certain downhole services are subject to the sales and use tax. Others are subject to the oil well servicing tax. What are downhole services? Downhole services are services performed within or through the well bore. Downhole services include all associated activities of the well service company on or above the surface, and those at or away from the well site. This includes such services as preparation or transportation, which are a necessary part of the downhole service being performed.

Examples of Taxable Downhole Services. These services are subject to the sales and use tax on services. They are not subject to the oil well servicing tax.

- Changing a downhole pump;
- Performing a rod/tubing job;
- Fishing for rods/tubing;
- Repairing tubing leak;
- Changing packer or anchor;
- Hot oil or water treatment of casing or tubing
- Injecting maintenance-type chemicals such as corrosion inhibitors and bactericides into the wellbore;
- Removing paraffin from the inside of the casing;
- Squeezing cement (taxable January 1, 1988 if to repair casing);
- Pulling or resetting casing liner (taxable January 1, 1988 if to repair casing string);
- Plugging and abandoning, temporary (to stop corrosion while the well is not producing.);
- Swabbing to clean casing; and
- Changeover/conversion of an artificial lift (Comptroller Letter 9105L110C10).

Example. Gauging (pumping) Services - Separately stated charges for providing gauging services (i.e., reading production information on an oil or gas well location and reporting the results to the operator of such well) are not taxable. Reading gauges and providing written reports is a nontaxable service. Pumping services to make adjustments to oil and gas well instruments that affect well production are taxable. Maintaining equipment or providing repairs, even minor repairs, of equipment at a well site is classified as a taxable service.

Example. Pumping (jetting) fluids downhole has two distinct purposes; to work on the formation or to effect downhole equipment (tangible personal property). It does not matter whether the fluid is an acid, chemical, water, mud-water, nitrogen, etc. the taxability of the service is determined by the primary purpose for the service. Of course, after each service is performed a secondary benefit may result. For example, pumping nitrogen downhole to wash out the well is taxable. The primary purpose is to clean the corrosion, bottom sand, or other debris out of the tubulars or casing; increased production is a secondary benefit because these items are cleaned and allow more product to flow out of the well. Likewise, pumping nitrogen downhole and forcing it into the formation in an effort to move the product to the surface in a more efficient is not taxed even though the tubulars, casing, etc. may be cleaned in the process.

Example. Fluid Level Service (to determine the annulus fluid level in various wells and provide report) - nontaxable. The treatment of a producing well with heated oil or water in order to melt accumulated paraffin in the annulus, tubing or flow lines through which the oil travels is taxable. *See* Rule 3.324(d)(1)(E).

Example. Wireline (Slickline) Services - If the wireline service is not directly related to starting or stimulating production, as discussed in Rule 3.324, then the service is the performance of a taxable service and the total job is taxed.

Example. Gas Lift Equipment Service (cleaning and testing gas lift valves) – The total charge is taxable. Rule 3.324 (a)(2).

Example. Production Packer Equipment Service (clean, inspect and repair used packers) - Total charge is taxable. Rule 3.324 (a)(2).[101]

Service Company Equipment. The well service company must also pay sales tax on any machinery or equipment the well service company purchases or rents to provide the service and on any materials (except cement) used or consumed in providing the service which do not become a part of the items inside the wellbore.

Example. Rubber goods such as stripper rubbers and swab cups.

Stripper rubbers are used in well workover and intervention. Stripper rubber is the sealing element used in coiled tubing or snubbing stripper systems. The stripper element is a consumable product and generally should be replaced for each operation. Coiled tubing elements can be replaced with the tubing in place, enabling a worn or leaking element to be replaced during an operation. Snubbing stripper rubbers are of single-piece construction and cannot be changed with the work string in place.

Swab cups are used in swabbing to bring oil to the surface. Swabbing reduces pressure in a wellbore by moving pipe, wireline tools or rubber-cupped seals (swab cups) up the wellbore. If the pressure is reduced sufficiently, reservoir fluids may flow into the wellbore and toward the surface. Swabbing is generally considered harmful in drilling operations, because it can lead to kicks and wellbore stability problems. In production operations, however, the term is used to describe how the flow of reservoir hydrocarbons is initiated in some completed wells.

Swab valve. The swab valve is used to control access to, and isolation of, the wellbore when performing well-intervention operations such as slickline, electric wireline or coiled tubing.

Component Parts or Materials. The parts and materials which become part of the wellbore are considered to be sold as a part of the taxable service and may be purchased tax-free by the provider of the taxable service. Care, custody and

[101] Comptroller Letter No. 9803236L (Gilbert Zamora, March 30, 1998).

control of the component parts and materials transfer to the well owner as part of the service.

Nontaxable downhole services: Downhole services that would otherwise be taxable may be performed in order to facilitate a nontaxable service (e.g. pulling tubing to perform workover). This will render the taxable service nontaxable.[102]

Charges for labor to start or stimulate production or for labor to work on formation outside the well is generally nontaxable (pumping the product is not considered to be stimulating production):

- Fracturing
- Perforating
- Squeeze cement
- Workover
- Acidizing formation
- Logging the formation
- Drilling deeper
- Plug back
- Completion
- Plug and abandon, permanent (temporary would be taxable)
- Pulling and resetting casing liner (taxable as of 1-1-88 if to repair casing string)
- Installation of casing liner in well completion or workover
- Drilling out a plug
- New installation of artificial lift (e.g., rod pumping, centrifugal pumping, gas lifting, hydraulic pumping, etc.)
- Running a bottom hole bomb
- Swabbing to stimulate production
- Jetting to enhance production or recovery
- Gravel packing
- Hot oil treatment of the formation

Facilitating Non-taxable Services. Taxable downhole services may be performed in order to facilitate a nontaxable service. For example, pulling tubing to perform a workover is normally taxable. However, when the tubing is pulled in order to perform a workover, the otherwise taxable service becomes nontaxable. It is not unusual for two separate work crews to be used to maintain a well, e.g., one crew pulls the rods and another performs the workover. The charge for both crews' labor will be taxable or nontaxable depending upon what ultimate service is being done to the well. The act of replacing an item (supplied by the well owner) while performing a nontaxable service will not cause the labor to become taxable. However, performing a nontaxable downhole service in connection with taxable above-ground services will not convert the above-ground services into nontaxable services.

Important Note. The well service company's work orders and invoices should describe the exact work being performed so that it can be established whether or not the labor is taxable. If the Comptroller's auditor cannot determine which ultimate service is actually being provided, he or she will tax the total charge including mileage, trip fees and standby time.

Repairing or restoring real property. Charges for labor to repair, remodel, or restore improvements to real property at a lease site are taxable.[103] The typical

102 Comptroller Rule 3.324.

103 These services became taxable on January 1, 1988.

types of real property found at oil and gas well sites[104] include:

- Pump stations, booster stations;
- Casing in place;
- Enhanced production-injection and recovery systems which cannot be moved intact. (Does not include equipment on lease or water well pump.);
- Storage facilities (tanks or batteries) each with a storage capacity of more than 500 barrels;
- Vapor recovery systems at service stations;
- Compressors at compressor stations other than leased compressors;
- Production platforms with their supports permanently embedded in the sea bed;
- Water disposal systems - same guidelines as storage facilities;
- Gathering lines and flow lines which are buried;[105] and
- Gas processing plants not easily movable.

In addition, the following real property is used in the oil and gas industry but may not be located at the well site:

- Underground storage facilities;
- Pipeline transmission lines;
- Machinery, equipment, and fixtures which are attached components of processing or manufacturing facilities. Items which are free-standing or which are bolted down but are readily removed without damage are tangible personal property;
- Permanent lighting.

[104] These are the items listed as real property in the audit manual.
[105] Or partially buried (prior to July 1, 1985).

Example. The components of gathering lines (pipe, valves, etc.,) when initially purchased are tangible personal property. Once these items are connected and put in place for use they remain tangible personal property or become improvements to realty.[106] The basic definition for the classification of these lines is based upon their use.

Gathering lines are the lines from lease tank batteries to the transmission or trunk pipeline.[107] Gathering lines are then broken into two classifications: real property or tangible personal property.[108]

Underground gathering lines are real property. The portions of underground gathering lines that are laid above ground, such as at river crossings or the risers containing the valves, are also real property.

Above-ground gathering lines are tangible personal property. Gathering lines that are above ground but under water are tangible personal property, not improvements to realty.

Work performed on gathering lines is taxed according to the type of work performed and the classification of the line as tangible personal property or improvements to realty. For example, the sale and installation of an above-ground gathering line is the sale and installation of tangible personal property; the seller must collect tax on

[106] *See* Comptroller Letter No. 9410L1318F05.
[107] *See* industry books titled, Modern Petroleum- A Basic Primer of the Industry *and* Manual of Oil and Gas Terms.
[108] In 1991, the audit division requested a definitive position on flow lines, gathering lines, and transmission lines. A response was provided in TR 1241.

the total amount. However, the sale and installation of an underground gathering line is new construction; the charge for new construction labor is not taxed; the contractor's tax responsibility is determined by the type of contract: lump-sum versus separated.

Well Site Grounds Services. Charges for certain real property services, such as patching roads, pest control, and others became taxable on October 1, 1987. As they relate to the well servicing industry, the following real property services are taxable:

- Patching holes in roads at the lease site;
- Lease road blading if it is not scheduled and recurring;
- Pest control services at the well site by a licensed exterminator; and
- Certain surveying charges associated with drill site preparation.

The following real property services are not taxable:

- Covering oil spills at the lease site;
- Reclamation services performed to restore oil and gas lease properties to their original condition;
- Removing waste materials from the lease site which result from activities performed in the exploration and production process;
- Lease road blading when scheduled and recurring;
- Landwork at the lease site; and
- Picking up trash, cutting weeds or grass around the lease site.

Garbage Collection. While waste removal is a taxable service, fees paid for the removal of industrial solid waste are exempt from sales tax. Industrial solid waste includes the solid waste resulting from or incidental to a process of industry, manufacturing, mining or agricultural operations.[109]

Example. Weed Control. Landscaping activities, such as cutting or mowing grass and weeds, are taxable as real property services when performed for aesthetic purposes. When performed at an oil or gas well site, water disposal or injection well, these services are not taxable real property services, so the service provider does not need to collect the sales tax.[110]

Example. Mowing at Lease Sites. Mowing or trimming that is performed on private or commercial yards or lawns is a taxable service. However, mowing or cutting to clear land for buildings, power line rights-of-way, pipeline rights-of-way is not taxable. The charge for cutting weeds, mowing, or trimming weeds or grass at lease sites (oil or gas) is not taxed because the activities are not performed on private or commercial yards or lawns. However, mowing or trimming, etc., that is performed on the farmer's or rancher's yard or lawn is taxed. These answers apply whether the farmer, rancher, or oil company pays for the service.[111]

Example. Pest and Weed Control for Real Property. On the other hand, pest control services to kill insects or remove weeds at an oil field or related location, such a well site, compressor or booster station, etc., through the use of pesticides, herbicides or other similar chemicals are taxable as structural pest

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[109] Texas Health and Safety Code, Ch. 361

[110] *See* Rule 3.324. *See also* Tax Policy News, May 2012.

[111] Comptroller Letter No. 9410L1329G03.

Back to Table of Contents

control services regardless of whether an aesthetic effect is achieved.[112] Structural pest control services that use chemical means to prevent, control, or eliminate an infestation of weeds, wood-infesting organisms and other pests are considered taxable real property services.[113]

Example. Pest Control for Tangible Personal Property. At some oil field related locations, some of the machinery and equipment is tangible personal property and not deemed to be either a structure or improvement to realty. For example, a pump jack, flow line, heater treater, separator, or wellhead christmas tree is tangible personal property. Pest control services provided at a location where there are only items of tangible personal property are not taxable structural pest control services.[114]

Tanks with a capacity of 500 barrels or less are also considered tangible personal property. Tanks with a capacity exceeding 500 barrels are considered to be a structure or improvement to realty. Therefore, the charge for the pest control service at the well site should be separately stated for the services related to structural/realty components and the tangible personal property in order for the sales tax to only apply to the structural/realty components. Otherwise, sales tax would apply to the total combined charge if the service relating to the structural/realty components represents more than 5.0% of the total charge.[115]

Example. Cleaning up Oil Spills at Lease Sites. The charge to clean up oil spills regardless of the location is not taxed because it is exempt hazardous waste removal.[116]

Example. Land Work at Saltwater Disposal. Land work performed on existing sites is generally considered repair and is taxed. Land work performed in preparation for new construction is not taxed, and land work that occurs after the site is closed to reclaim the land to its original condition is not taxed.[117]

Example. Building dikes around tank battery pads. If the dike around the tank battery is a mound of dirt, positioning the dirt for the first time into a new dike is new construction. Reconfiguring or restoring the dike is taxable as nonresidential repair or remodeling.[118]

Example. Patching Roads. The total charge to patch roads is taxed as the repair of nonresidential improvements to realty. However, if a road serves both as a driveway to a residence and to a lease site or for agricultural use, then the portion up to the residence is residential realty, past the residence to the lease site or for agricultural use is nonresidential realty. The labor to repair residential realty is not taxed.[119]

Example. Digging Work Pits. Digging a new pit is classified as new construction; the labor charge is not taxed. Cleaning out or re-digging an existing pit is restoration of

112 *See* Tax Policy News, May 2012.
113 Applying to pesticides covered under Occupations Code § 1951.003.
114 *See* Tax Policy News, May 2012.
115 *See* Tax Policy News, May 2012.

116 Comptroller Letter No. 9410L1329G03.
117 Comptroller Letter No. 9410L1329G03.
118 Comptroller Letter No. 9410L1329G03.
119 Comptroller Letter No. 9410L1329G03.

Back to Table of Contents

nonresidential realty; this is a taxable service and the total amount is taxed.[120]

Example. Repairing Flow Lines. Flow lines are the lines from a well to a storage tank. Above-ground and underground flow lines are tangible personal property. The total charge to repair flow lines is taxable.[121]

Example. Pulling Trucks. The charge for pulling trucks out of the mud or for pulling trucks from one location to another is not taxed.[122]

Five Percent Rule. Taxable services should be separately stated and identified from nontaxable services on the invoice or contract. If not, the total charge is presumed taxable when the charges for taxable services and nontaxable services are billed as one amount and the sum of the charges for taxable services is greater than five percent of the total charge.[123]

Oil and Gas Well Formation Services.[124] After an oil or gas well is drilled, the operator must usually test and log the well to determine if a formation will produce oil or gas. If so, the operator must evaluate the potential of the pay zone. Once the operator determines that the formation is productive, the drilling is completed and the casing set. If the well has sufficient natural drive, it will begin flowing freely. If not, some form of well stimulation may be needed to start production.

Existing Wells. After oil or gas wells produce oil and gas, they may need cleaning (workover) to clear the well of deposits or they may need repairs since parts of the oil and gas well equipment wear, corrode and break. Also, a producing well may lose some or all of its natural drive, and the operator may need to hire a well service company to stimulate the well or to provide artificial lift in order to recover any remaining oil in the formation.

Well Servicing Activities. A well servicing company performs services in several areas:

Testing and logging. This includes tests to determine a well's potential for production and well logging which is done to locate productive formations within the wellbore;

Stimulation. A well service company stimulates a well in order to increase the flow of oil from the well. It does this by performing the services of cementing; fracturing; acidizing; perforating and shooting formations; and swabbing;

Making repairs. A well service company performs repairs and workovers to keep a well in production, performs maintenance work to improve or maintain the production, or to correct problems. Some examples include:

- repairing or replacing sucker rods, tubing, pumps, anchors, etc.;

120 Comptroller Letter No. 9410L1329G03.
121 Comptroller Letter No. 9410L1329G03.
122 Comptroller Letter No. 9410L1329G03.
123 Comptroller Rule 3.324.
124 The content of this section was developed from the Comptroller's Oil Well Servicing Tax Policy Manual. It therefore contains only the Comptroller's interpretation of the taxability or non-taxability of various services. Such interpretations may or may not be the same interpretations a court would apply to the underlying statutes.

Back to Table of Contents

- fishing for equipment or tools lost downhole;
- removing paraffin from the casing or tubing;
- injecting maintenance-type chemicals, such as corrosion inhibitors and bactericides into the wellbore;

Installing artificial lift equipment. This includes gas lift equipment, sucker rod pumps, hydraulic pumps, saltwater injection equipment, and steam injection equipment.

Repairing and maintaining surface equipment. This includes the repair, maintenance, and installation of above-ground equipment, like:

- pump jacks and associated equipment
- gathering and flow lines
- tank batteries
- temporary fences
- board roads

Repairing and Maintaining the Oil Well Site. This includes repairing or maintaining:

- lease roads
- well sites
- cattle guards
- permanent fences
- tanks in excess of 500 barrels

Transporting Products and Materials. This includes transporting:

- salt water
- fresh water
- drilling mud
- various chemicals used downhole
- disposal of waste products

I. Well Servicing Tax.

Types of Taxable Services. The Texas Tax Code imposes an "Occupations Tax" equal to 2.4 percent of the gross receipts received from performing these particular oil well services:

- Cementing the casing seat
- Shooting the formation
- Fracturing the formation
- Acidizing the formation
- Surveying a well
- Testing the formation

Within each of these oil well services, there both taxable and non-taxable categories. We discuss each, in turn, below:

Cementing. Cementing is one of the first steps in well completion and is normally provided by a well servicing company and not the driller. Cement is brought to the well site in large transport trucks, mixed with water at the well, and forced into the wellbore in order to:

- Restrict fluid movement between formations and to the surface;
- Provide support for the casing;
- Prevent pollution of fresh water formations; and
- Prevent corrosion of the casing.

An oil or gas well usually requires as many as three concentric strings of pipe or casing which are all cemented in place:

- The conductor pipe. The conductor pipe is needed to prevent the wellbore from caving in at the surface. In very soft ground, the conductor pipe may extend down from the surface to 100 feet or more, but generally no more than 20 feet is required. The conductor pipe is usually cemented in place, but occasionally it is driven into place by means of a pile driver. Cementing of the conductor pipe is not a taxable service.

- The surface casing. The surface casing provides protection for freshwater formations, prevents loose shale, sand or gravel from falling into the hole, and affords a means of controlling the flow of drilling fluids from the well. The surface casing is run to a greater depth than the conductor strings but does not run to the producing zone. Cementing of the surface casing is not a taxable service.

- The oil string or production string. The final casing for most wells, to prepare the well for production, is the production string, or oil string. In most wells the production string of casing is the last column of casing placed in a well and will extend from the surface through the producing or "pay" zone.

In some cases where the producing formation is tightly consolidated, the production string is run only to the top of the producing formation, and the hole is left open below that point. This is an "open hole completion" or a "barefoot completion."

In other instances, it is found desirable for economic reasons, or to facilitate subsequent operations, to run a shortened string of casing in the bottom portion of the hole, that will not extend to the surface but only to a portion already cased. This casing, used to extend the casing from the producing zone to a point already cased, is usually called a "liner."

In addition to the conductor pipe, surface casing and the oil string, an intermediate string of casing is often needed as a precautionary measure in nearly every deep well, and it is often needed in other wells when high pressure or troublesome formations are encountered. This casing is set in the wells after the surface casing and before the oil string.

In all methods of preparing the well for production, the column of casing at the bottom of the producing string is referred to as the "casing seat" or "shoe." This is taxable.

Cementing of the casing seat is the operation by which cement is placed between the bottom of the casing and the sides of the wellbore for the purpose of securing the casing in place and excluding water and other fluids from the hole. The cementing of a casing seat commences with the placing of the production string in the well and ends when the cement is in place. This is a taxable service.

The cementing material is mixed in a liquid state (slurry) at the surface and usually is either:

- Hydraulically pumped to the bottom of the wellbore through the casing, or through auxiliary tubing and is forced up behind the casing; or
- Lowered to the bottom of the hole in a bailer and dumped there.

Taxable Cementing Services. The cementing of the casing seat, or the seat of liners when used as extensions of the production string, is the only taxable cementing service.

Services which are taxable when performed, or made available during or in association with cementing of the casing seat or the seat of liners, include, but are not limited to:

- mixing the cement slurry at the well;
- blending additives and/or inhibitors into the slurry at the well;
- setting packers, hangers, or any other equipment into the well when the service is performed by the person doing the cementing, and when the service is associated with cementing the casing seat;
- pumping the slurry, or any other material;
- using any specialized equipment used in cementing the casing seat;
- any other services performed while cementing the casing seat; and
- occupation tax reimbursement.

Non-Taxable Cementing Charges. Charges for the following cementing services are not taxable:

- mileage and/or stand-by charges;
- material used, consumed, or expended in or incorporated into the well;
- cementing of the conductor pipe or an intermediate string of pipe;
- cementing to control the movement of fluids behind the casing, to correct lost circulation, or to repair casing leaks;
- cementing to re-complete the well at another depth;
- plug-back operations (plugging);
- cementing for abandonment;
- squeeze cementing;
- cementing for whipstock operations;
- cementing to repair defective casing or cementing liners for remedial or repair operations; and
- pouring pads for wellhead equipment;

Shooting, Fracturing, or Acidizing. Shooting. The charge for shooting the producing zone in an oil or gas well is subject to tax. Shooting refers to the detonation of an explosive within the well bore and in the proximity of the producing zone for the purpose of fracturing the zone so the oil and/or gas will move more freely into the well bore. This is the only shooting service subject to the tax.

Other non-taxable shooting services which may be performed include, but are not limited to:

- destroying objects lost/stuck in the hole ("fishing");
- cutting casing;
- cutting or freeing stuck drill pipe;
- perforating the casing;[125]
- clearing screens, strainers, or perforations ("string shot shooting").

Acidizing and Fracturing. Acid is extensively used in the oil and gas producing industry. However, the only acid service subject to tax is whenever the acid is injected into the earth's formation. This is referred to as "acidizing the formation." The objective

[125] Industry research continues for a method in which the casing can be perforated and the formation fractured during one operation, which would result in a taxable service. This technology is apparently not available at the present time.

is to increase the rate of flow of oil and/or gas into the well bore.

Various chemicals may be mixed with the acid to:

- prevent damage to down-hole equipment (inhibitors);
- prevent foaming (surfactants);
- prevent scaling (sequestering agents);
- cause suspension of fine particles to prevent clogging (suspending agents).

The total charge for acidizing the formation, less the cost of materials, is subject to tax.

The charge for fracturing the formation is subject to tax. Like acidizing, the primary purpose of fracturing the formation of a producing oil or gas well is to increase the rate of flow into the well bore.

Fracturing is accomplished by pumping a carrier (diesel fuel is popular) and propping agents (i.e., ceramic beads) under extremely high pressure through the tubing or the casing into the formation until the producing zone is "cracked or fractured."

The propping agents remain in the cracks after the pressure is released; thus, serving to "prop" open the formation to allow the oil and/or gas to flow into the well bore.

Taxable Services. Services which are taxable when performed, made available during or in association with acidizing or fracturing, include, but are not limited to:

- mixing the solutions at the well;
- blending additives or inhibitors into the fluid at the well;
- pumping charges for pumping the fluids, additives, inhibitors, and/or propping agents from storage tanks to the blender and/or the main injection pump at the wellhead and down the well;
- charges for the mixer;
- sealing perforated casing in multi-zone acidizing or fracturing jobs (i.e., ball injector service);
- perforating the casing if performed simultaneously with acidizing or fracturing (generally this is not done simultaneously); and
- specialized equipment charges, i.e., isolation tool, wellhead protection tool, manifolds, etc.

Nontaxable Services. Non-taxable services in connection with acidizing or fracturing include:

- tank rental;
- mileage, stand-by charges, or "waiting time";
- acidizing to recover fish or stuck pipe;
- acidizing to clean screens or strainers;
- acidizing to dissolve mud sheaths on the wall of the hole;
- acidizing soluble metals (pipe or special tools);
- acidizing to dissolve paraffin deposits in the tubing;
- fracturing of injection or disposal wells; and
- perforating the casing in preparation for acidizing or fracturing.

Surveying or Testing. Surveying or testing the sands or other formations or their contents by using instruments or equipment, at least a part of which are

Back to Table of Contents

located in the well bore when the survey is made, is one of the services subject to the well servicing tax.

Logging. Surveys of the sands or other formations are normally recorded on some medium, and are referred to as "logs." Thus, this activity is also known as "logging." Logging can be placed into three broad categories:

- open-hole logging
- cased-hole logging
- mud logging

Surveys. Surveys also include: fluid level surveys; dip meter surveys; fluid ingress or egress surveys; deflection, deviation, and inclination surveys; depth surveys; corrosion surveys; and tracer surveys.

Testing. The most common tests are:

- drill stem tests
- pressure tests
- productivity index tests
- potential tests
- core tests
- sidewall core tests
- gas/oil ratio tests
- bottom-hole test

Taxability of Testing and Surveying. It is impossible to say whether a particular test or survey is always taxable or exempt. A test or survey is taxable if it meets the conditions of taxability:

- it must be a test or survey of the formation or its contents;
- instruments or equipment, or a portion of them, must be located in the well when the test or survey is conducted;
- the test or survey must be conducted during the drilling or completion, or re-working or re-completion of the well;
- the test or survey must be conducted by a person other than the one drilling the well.

Specific Rules.

Acoustic logs. They measure the porosity of the formation by recording sound wave reflection. These are taxable. If the acoustic log is used to survey a cement job, it is not taxable.

Caliper log. This is a mechanical log used to profile the wall of the well. It is not taxable.

Chlorine log. This is a nuclear log normally used to evaluate the presence of water in the formation. This log is usually run in older wells and would not be taxable since it is not run during the completion of the well. If the well is being re-completed, it would be taxable.

Collar log. This is a mechanical collar log is not taxable since it is not a log of the formation or its contents. It is common to find a collar log included with a radioactive log. If the radioactive log is taxable and the charge for the collar log is included in the total charge, it is also taxable. If the charge is separated, it is not taxable.

Core tests. These are rarely taxable since they are taken by the person drilling the well. If a company specializing in coring furnishes the core cutter and supervision, the charge would be taxable. The charge made by a person for analyzing the core is not taxable, since the service is not performed at the well.

Correlation log. These are also rarely taxable since the usual purpose is to position the perforating gun. These logs normally cover only a few hundred feet of the hole. The logging tool is usually run into the well along with a perforating gun. The casing collars are also normally located on this log to prevent perforating the collar.

Corrosion survey. This surveys the condition of the casing or in-hole equipment. It is not taxable.

Density log. This is a nuclear log generally used to evaluate the formation. It is usually taxable.

Depth survey. This survey measures the total depth of the well. It is not taxable.

Dip meter survey. This survey is generally used to calculate the dip (angle) of the formation. Normally requires a survey of two or more wells. It is usually done after the well has been completed and would not be taxable. If it is conducted during the drilling completion, re-working, or re-completion of the well, it is taxable.

Deflection survey. This survey is used to determine the direction of the hole. It is not taxable.

Deviation survey. This is same as deflection survey. It is not taxable.

Drill stem test. This is a production test of the contents of a particular zone conducted during the drilling of the well. A special tool is installed on the drill pipe. The tool and supervision are usually supplied by the person other than the driller, and the charge would be taxable.

Dual induction log. An electrical log. It is usually taxable.

Dual laterolog. Also an electrical log. It is usually taxable.

Electric logging. This is used in uncased holes to evaluate the formation. It is usually taxable.

Feeler log. This is same as a caliper log. It is not taxable.

Fluid ingress or egress survey. These are generally used to measure formation fluids entering or leaving the well bore with an instrument in the well. They are also known as a "spinner" survey or "water flow survey" - taxable. If this is used to measure drilling fluids only, it is not taxable.

Fluid level survey. This is a sonic survey used to determine the fluid level in the well. If any part of the instrument used is located within the well, the survey is taxable.

Focused log. This is an electrical log. It is usually taxable.

Gamma ray logging. This is one of the radioactive logging techniques. It is usually taxable.

Gas condensate tests. This is a test to determine the ratio of produced gas to liquid hydrocarbons. Instruments may be placed within the tubing or drill pipe. If such tests are conducted during drilling completion, reworking, or reconditioning of the well, they are taxable.

Gas/oil ratio test. This is a test to determine the ratio of produced gas to produced oil. It is not taxable since an instrument is not placed in the well.

Induction log. This is an electrical log. It is usually taxable.

Laterolog. This is also an electrical log. It is usually taxable.

Microlog. This is also an electrical log. It is usually taxable.

Microlaterolog. This is an electrical log. It is usually taxable.

Micro spherical log. This is an electrical log. It is usually taxable.

Mud logging. This involves the collection and analysis of cuttings contained in the drilling fluid. This is not taxable since it does not involve the placement of an instrument in the well.

Neutron logging. This is one of the radioactive logging techniques. It is usually taxable.

Nuclear logging. This is one of the radioactive logging techniques. It is usually taxable.

Potential tests. This is the analysis of pressures and flow rates to determine the productive potential of the well. This is not taxable if instruments are not placed in the well.

Pressure tests. These tests may or may not involve instruments placed in the well. They may be conducted throughout the life of the well. The only time they are taxable is when they are conducted during the completion or re-completion of the well, when an instrument is placed in the well, and when the purpose is to test the contents of the formation. The instrument used is referred to as a "bottom-hole bomb."

Proximity log. This is an electrical log. It's usually taxable.

Sidewall core test. This is the taking of a core from the sidewall of the well rather than the core of the well. See core testing.

Spherical focused log. This is an electrical log. It's usually taxable.

Spinner survey. This is same as fluid ingress and egress survey.

Temperature log. This is a record of the temperatures encountered at various depths in the well. This is a taxable service if it is to survey the fluids in the well. If it is used to check the results of cementing, it is not taxable.

Tracer survey. This survey traces fluid movement, usually behind the casing. If the purpose of the survey is to check the results of cementing to stop the undesirable movement of these fluids, it is not taxable. If the purpose is to analyze the movement of the fluids, it is taxable.

Important Note. Most surveys are run with a combination of several tools to save time and expense in obtaining the desired information. If a non-taxable service is run simultaneously with a service to survey the formation, the entire operation is taxable, if it is in direct connection with a primary taxable service. For example, a gamma ray and a collar log are run simultaneously. The collar log is not taxable because it has no connection with the gamma ray log.

Non-taxable Services. In connection with the services provided by a well servicing company, there are charges which are NOT taxable under the statute. These non-taxable charges include:

- The value of material used, consumed, expended in or incorporated into the well during the performance of a taxable service. If the charge for the service is not separately stated, the value must be determined and deducted from the total amount to arrive at the taxable amount of the service charge. In determining the value of the material, all reasonable or necessary elements of the value of the materials should be considered, including the cost of the materials, transportation, handling, profit on the sale, overhead, etc.
- Charges for "waiting time" or "stand-by time" since no service is being performed. "Waiting time" is the period of time when a piece of service equipment (pump, lines, or tanks) is connected to other service equipment during a cementing, acidizing, or fracturing job, but not put to immediate use. "Stand-by time" is the period of time when a piece of service equipment is at the well but is neither used nor connected to other service equipment. This may be before the service begins or during the time when no service is being performed due to causes beyond the control of the service company.
- Computer analysis of cementing, fracturing, acidizing, surveying or testing when performed at a location other than the well. However, the use of a computer or computer terminal at the well site will constitute a taxable service performed in or at the well.
- A temperature survey to determine the results obtained in cementing a casing seat unless performed in connection with a taxable service.
- Perforating and the taking of cores and cuttings.
- Services performed in converting an oil or gas well into an injection well.
- Receipts for equipment taken to a well but not connected in any way to the well or other equipment.
- Tax reimbursement equal to that actually paid for sales or use tax on materials and supplies.
- Receipts for frac tank services.
- Receipts for reasonable mileage charges.
- Receipts for services performed before or after a taxable service has been commenced or completed.
- A dip recording survey made for the purpose of determining where to drill subsequent wells, when not made in connection with the drilling and completion of the well in which it is made.

- Gas-oil ratio tests.
- Cementing of the conductor pipe and surface casing.
- Tax Reimbursement. Most well service companies bill their customers a tax reimbursement for the well servicing occupation tax. Since the occupation tax is imposed on the person performing the service, and not on the customer, this tax reimbursement becomes a part of the taxpayer's gross receipts subject to the occupation tax.[126]

[126] *See* Attorney General Opinion MS-172.

Back to Table of Contents

Chapter III. Exemptions

A. State Tax Exemptions for the Oil and Gas Industry

Texas tax laws exempt various processes and equipment used in the oil and gas industry in order to promote its economic growth in our state.

B. Sales & Use Tax Exemptions

Claiming Exemptions. An entity claiming an exemption may issue an exemption certificate in lieu of paying sales tax on an item.

Burden of Proof. Courts have held that the purchaser bears the burden of proving the exemption. The Comptroller and the courts construe all doubts in favor of non-exemption or taxability.

Contrasted with a Resale Certificate. A buyer provides an exemption certificate when the buyer or the item is not subject to the sales tax. A buyer provides a resale certificate when the buyer plans to resell the item. In the latter case, sales tax collection ultimately occurs when the buyer resells the item to a consumer.

C. Accepting an Exemption Certificate.

Presumptions. All of a seller's gross receipts are presumed to be subject to the sales tax unless the buyer furnishes the seller with a properly completed exemption or resale certificate. The sale of a taxable item by a person for delivery in Texas is presumed to be a sale for storage, use or consumption in Texas unless the seller accepts an exemption or resale certificate. The purchaser has the burden to claim the exemption to which he or she may be entitled.

Sales Tax Number Insufficient. If the seller does not receive an actual exemption certificate from the purchaser but instead receives only the purchaser's sales tax number, the seller should charge the purchaser sales tax on the transaction. The Texas Sales and Use Tax Act does not allow an exemption number or a tax-exempt number to be issued or used as a substitute for an exemption certificate.

Good Faith Acceptance. A sale is exempt if the seller receives in good faith from a purchaser a properly completed exemption certificate, and the seller lacks actual knowledge that the exemption is invalid.[127]

Reason to Suspect Invalid Certificate. A seller must look at the facts behind the exemption and reject an exemption certificate even if it appears to be valid if there is some reason to suspect that the exemption is being claimed in error. For example, no amount of documentation, including resale or exemption certificates, would cause a repair activity to be considered exempt maintenance.[128]

60 Day Rule. After an audit, sellers have 60 days after notification by the Comptroller to gather and submit

[127] The Comptroller's position is that resale and exemption certificates that aren't properly completed lose the good-faith presumption. Comptroller Hearing No. 41,214 (June 14, 2002).

[128] Comptroller Letter No. 908L0948E07 (August 18, 1989).

exemption certificates determined to be lacking. If the seller does not provide these certificates to the Comptroller within 60 days from the date the Comptroller gives written notice requiring possession of them, the Comptroller will disallow deductions claimed by the seller that require delivery of the certificates.

Good Faith Rule Suspended. The good faith presumption described above does not apply to the exemption certificates obtained during this 60 day period and the auditor will probably scrutinize them carefully.

When Exemption Certificates Are Not Needed. Note that certificates are only required in order to claim exemptions. Exclusions and exceptions (such as government purchases) do not require the seller to obtain or the purchaser to produce an exemption certificate. However, sellers should keep invoices, receipts, etc. on file as verification of nontaxable sales.

Content of an Exemption Certificate. An exemption certificate must show all of the following or the Comptroller will disallow it:

- Name and address of purchaser;
- Description of the item to be purchased;
- Reason the purchase is exempt from tax;
- Signature of purchaser and the date; and
- Name and address of the seller.

Special Requirements for Exempt Gas and Electricity. In addition to the usual exemption certificate requirements, an entity claiming the gas and electricity exemption must include the following:

- Specific statement of exemption: e.g. "A valid and complete study has been performed which shows that (insert the actual exempt percentage) of the natural gas or electricity is for processing tangible personal property for sale in the regular course of business."
- The original seal of the registered engineer who performed the study or a signed statement including the original signatures of the business owner and engineer.

Caution. Be sure to use the proper form of the Exemption Certificate, which is available on the Comptroller's website at:

http://www.cpa.state.tx.us/taxinfo/taxforms/01-forms.html.

The form must contain the criminal offense language.

Improper Use of an Exemption Certificate. A person commits an offense if he or she:

- Intentionally or knowingly makes a false entry in, or a fraudulent alteration of a resale or exemption certificate,
- Makes, presents or uses an exemption or resale certificate with knowledge that it is false and with the intent that it be accepted as a valid certificate, or
- Intentionally conceals, removes or impairs the verity or legibility of an exemption or resale certificate or

unreasonably impedes the availability of a certificate.[129]

An offense under (a) or (b) above is punishable commensurate with the amount of tax avoided by use of the exemption or resale certificate:

Tax Avoided	Classification
Less than $20	Class C Misdemeanor
$20-199	Class B Misdemeanor
$200-749	Class A Misdemeanor
$750-19,999	3rd Degree Felony
> $20,000	2nd Degree Felony

Taxable Use/Divergent Use. When an item purchased under a valid exemption certificate is used in a taxable manner, whether the use is in Texas or outside the state, the purchaser is liable for payment of sales tax based on the fair market rental value of the item for the period of time used. If the item has no fair market rental value, or if the exemption certificate is invalid at the time of issuance, the purchaser owes tax on the original purchase price.[130]

Example. Smitty Pipe & Supply sells equipment and supplies for performing downhole services. Smitty also performs nontaxable well services under lump sum contracts. Smitty purchases supplies using a resale certificate and places them in inventory. One day, while servicing a well, Smitty needs to remove parts from inventory for use in the nontaxable service. This is a divergent use. Smitty must accrue and remit use tax on the price it paid for the parts when it takes them out of inventory and uses them in performing the nontaxable service.

D. Resale Exemption.

In General. A sale of a taxable item for resale is exempt from sales and use tax. A sale for resale is defined as a sale of a taxable item to any purchaser who is purchasing the item for the sole purpose of reselling, leasing or renting it within the geographical limits of the United States of America, its territories and possessions, in the normal course of business either in the form or condition in which it is purchased, or as an attachment to, or integral part of, other taxable items.

A purchaser may give a properly completed resale certificate to a Texas seller if acquiring a taxable item for the purpose of selling, leasing or renting the item in Mexico in the normal course of business. The resale certificate must show the purchaser's Mexican federal identification number in addition to the other required information.

Resale of Services and Materials Used in Services. The definition of "sale for resale" includes sales of taxable services performed on tangible personal property held for sale by the purchaser of the taxable service and tangible personal property sold to a purchaser who acquires the property for the purpose of transferring it as an integral part of a taxable service. Tangible personal property used to perform a taxable service is not considered resold unless care, custody and control of the

[129] Texas Tax Code § 151.707 (effective September 1, 1993).

[130] There is a special rule for divergent uses of tangible personal property used in manufacturing, which is discussed later in these materials.

property is transferred to the purchaser of the service.[131]

Example. Arturo's Well Servicing performs taxable downhole well services under lump-sum contracts. Arturo may issue a resale certificate when he purchases chemicals for use in taxable downhole services as long as Arturo will transfer care, custody and control of the chemicals to the customer as part of the taxable service.

Commingled Goods. If a purchaser commingles fungible goods purchased under a resale certificate with similar goods for which no certificate was given, sales from the mass of commingled goods are deemed to be sales covered by the certificate up to the quantity of goods covered by the certificate.

E. Resale Certificates.

In General. A sale is exempt if the resale certificate is accepted in good faith and the seller lacks actual knowledge that the sale is not a sale for resale. It is the seller's responsibility to take notice of the type of business generally engaged in by the purchaser as shown on the resale certificate.

Same General Restrictions as Exemption Certificates. The same documentation requirements that apply to exemption certificates also apply to resale certificates.

Requirements. A resale certificate must show the following:

- Name and address of the purchaser;
- The number of the sales tax permit held by the purchaser or a statement showing that an application for a permit is pending, including the date the application was made. If the application is pending, the certificate is valid for 60 days, after which time the certificate must be renewed to show the permit number. Federal identification numbers or social security numbers are not acceptable evidence of resale;
- A description of the taxable items generally sold, leased or rented by the purchaser in the regular course of business and a description of the taxable items to be purchased tax free by use of the certificate;
- The signature of the purchaser and the date; and
- The name and address of the seller.

Retailers Outside Texas. A seller in Texas may accept a resale certificate in lieu of tax from a bona fide retailer outside Texas who purchases taxable items for resale. The resale certificate must show the signature and address of the purchaser, the state to which the property is taken for resale and the sales tax permit number, if any, or the registration number assigned to the purchaser by the purchaser's home state. The resale certificate must also state the type business engaged in by the purchaser and the type items sold in the regular course of business. An invoice describing the taxable item purchased and showing the exact street address or office address from which the taxable item will be sold must be attached to the resale certificate.

[131] Comptroller Letter No. 200209434L (Sept. 19, 2002), stated that sea salt purchased for use in an aquarium at a zoological facility was taxable, rather than being exempt as property transferred as part of a taxable amusement service.

F. The Manufacturing Exemption

The Texas Tax Code provides several exemptions from sales tax to promote industry and prevent multiple taxation of manufactured products that are sold (and thereby taxed) at retail. Generally, materials and equipment that are used or consumed in manufacturing, processing or fabricating products to be sold at retail are exempt from the sales and use tax.[132]

First Production Stage. The "first production stage" means the first act of production. It does not include acts in preparation for production.

Example. A Comptroller letter considered whether line heaters qualify for the manufacturing exemption.[133] Line heaters are used in the oil and gas industry to (1) reverse the temperature and pressure drop that occurs when natural gas is extracted from the earth, and (2) begin the process of breaking out gas and liquids during the separation process. The Comptroller's position is that line heaters used for these purposes do not qualify for the manufacturing exemption because these are activities which are performed in preparation for production. The manufacturing exemption only applies to equipment used from the first production stage forward, and does not apply to pre-production activities.

Manufacturing. A manufacturer is a person engaged in manufacturing and includes processors, fabricators and custom manufacturers.[134] Manufacturing includes each operation beginning with the first stage in the production of tangible personal property and ending with the completion of tangible personal property having the physical properties (including packaging, if any) that it has when transferred by the manufacturer to another.[135]

Pre-production. Before determining whether equipment or supplies are exempt, the taxpayer must first determine whether the equipment or supplies will be used while manufacturing or processing is occurring. Bringing oil to the surface is not processing, fabrication, or manufacturing. Some confusion exists in this area because the term "production" is generally used in the oil and gas industry to refer to the activity of bringing oil to the surface of the earth. The term "production" is also used to describe the manufacturing of an item of tangible personal property. The statutory language applies the manufacturing exemption only to "manufacturing, processing, or fabrication," which generally requires that a chemical or physical change occur in order to bring the product being manufactured closer to being ready to sell. The Comptroller has determined that the oilfield producers are not manufacturing or fabricating when they transport the oil from its subsurface location to the surface or when they move the oil.[136]

Processing. Processing occurs when the oil is being treated or changed in some way, processing is being done. Processing has been defined for sales tax purposes in terms of an act or series of

132 Comptroller Rule 3.300.
133 Comptroller Letter No. 200404645L.
134 Comptroller Rule 3.300(a)(8).
135 Comptroller Rule 3.300(a)(9)(A).
136 Comptroller Letter No. 9612121L (Kevin Koller, December 11, 1996)

acts which brings about a physical or chemical change in an item. Texas tax law exempts substances used for the purpose of creating a physical or chemical change in the oil.[137]

Qualifying Items. The following categories of items are exempt from sales and use tax:[138]

Component Parts. Tangible personal property that will become an ingredient or component part of tangible personal property manufactured, processed or fabricated for ultimate sale;[139]

Example. Oil soluble chemicals will be generally considered to be exempt because they become an ingredient or component part of the oil to which they are added, assuming that the oil is sold. Chemicals which are not oil soluble but which are used to treat or cause a physical or chemical change in the oil would also be exempt. Chemicals which are not oil soluble and which are used for the purpose of protecting the pipes or other equipment are not entitled to an exemption, because they are not used in processing. This would generally include corrosion inhibitors which are intended to protect or coat pumps, pipes, etc.[140]

Direct Use Equipment. Tangible personal property directly used or consumed in manufacturing, processing or fabricating tangible personal property for ultimate sale. The use or consumption of the property must be "necessary or essential" to the manufacturing, processing or fabricating operation and the use must directly make or cause a chemical or physical change either to the preliminary, intermediate or final product being manufactured for ultimate sale.[141]

Dehydration equipment - Dehydration is the loss of water from cement slurry or drilling fluid by the process of filtration. Dehydration results in the deposition of a filter cake and loss of the slurry's internal fluid into a porous matrix. The cement is not completely dehydrated because sufficient water remains to allow setting of the cement. Dehydration equipment is used to create the proper moisture level for manufacturing. The equipment is therefore exempt from sales and use tax under the manufacturing exemption.

Heater treaters - A heater treater transfers heat to the produced gas stream. Heater treaters are used to treat oil-water emulsions so the oil can be accepted by the pipeline or transport. Heaters are especially used when producing natural gas or condensate to avoid the formation of ice and gas hydrates. These solids can plug the wellhead, chokes and flowlines. Heaters may also be used to heat emulsions before further treating procedures or when producing crude oil in cold weather to prevent freezing of oil or formation of paraffin accumulations.[142]

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137 Comptroller Letter No. 9612121L (Kevin Koller, December 11, 1996)

138 Texas Tax Code § 151.318

139 Beginning October 1, 1997, the property must be directly used or consumed in the manufacturing, processing or fabrication of the property. Tex. H.B. 1855, 75th Leg.,R.S., (1997).

140 Comptroller Letter No. 9612121L (Kevin Koller, December 11, 1996).

141 Tex. H.B. 1855, 75th Leg., R.S. (1997) (amending Texas Tax Code § 151.318, "Property Used in Manufacturing").

142 Comptroller Letter No. 9609L1435A12 (Gilbert Zamora, September 3, 1996), Comptroller Letter No. 9702256L (Lindey Osborne, February

Separators - A separator is a cylindrical or spherical vessel used to separate oil, gas and water from the total fluid stream produced by a well. Gravity segregation is the main force that accomplishes the separation, which means the heaviest fluid settles to the bottom and the lightest fluid rises to the top. Additionally, inside the vessel, the degree of separation between gas and liquid will depend on the separator operating pressure, the residence time of the fluid mixture and the type of flow of the fluid.

Gun barrels - A gun barrel is a settling tank used for treating oil. Oil and brine are separated only by gravity segregation forces. The clean oil floats to the top and brine is removed from the bottom of the tank.[143]

Example. A Comptroller hearing considered whether booster pumps and recompressors qualify for the manufacturing exemption. A booster pump directly makes or causes a chemical or physical change in crude oil being processed. The booster pump separates carbon dioxide (CO_2) from gas steam. The ALJ determined that the booster pump that separates the CO_2 from the gas steam is making a chemical or physical change to the item being manufactured, so the booster pump qualifies for the manufacturing exemption.[144]

The compressed CO_2 is then transferred into a liquid pump located at the field booster pump where it is mixed with other CO_2 of approximately the same pressure, further compressed and re-injected into the oil formation to further encourage additional oil production. The recompressors repressurize the recycled CO_2 for reinjection into the well formation. The Comptroller's ALJ determined that the recompressors were also exempt because they were directly used during processing and were necessary and essential because the CO_2 will not enter the formation until it is pressurized. Moreover the compression physically changed the CO_2 itself, which is an intermediate product that becomes part of the recovered oil and natural gas.

Chemicals & Catalysts. The manufacturing exemption includes chemicals, catalysts and other materials used during a manufacturing, processing or fabrication operation to produce or induce a chemical or physical change, to remove impurities or to make the product more marketable.

Example. A compressor used by a gas operator is exempt if used to compress gas to a contractual target sales pressure or used to operate a gas dehydration unit to process or manufacture tangible personal property for sale. Lubricants and coolants used in these compressors qualify for the manufacturing exemption.[145]

Example. Lubricants and coolants (antifreeze) used in drivers for salt water disposal pumps are not exempt. The salt water disposal pump is not processing or manufacturing equipment. A compressor that is used to transport oil and gas or to power equipment or

13, 1997) and Comptroller Letter No. 9910770L (Gilbert Zamora, October 13, 1999).

143 Comptroller Letter No. 9609L1435A12 (Gilbert Zamora, September 3, 1996)

144 Comptroller Hearing No. 40,528 (2002).

145 Comptroller Letter No. 9612121L (Kevin Koller, December 11, 1996).

facilities not directly used in manufacturing tangible personal property for sale is not processing or manufacturing equipment. Lubricants and coolants used in this equipment do not qualify for the manufacturing exemption.[146]

Example. Chemicals and catalysts used to protect production equipment also do not qualify for the exemption. Sulfate reducing anaerobic bacteria exist and multiply without oxygen. They usually exist in the tubing-casing annulus of production wells. Therefore, producers must use Biocide and MicroBiocide to control or restrain the bacteria growth. The chemicals are used to keep equipment from clogging or jamming or corroding. While these chemicals and catalysts beneficially affect the oil produced, these effects are the positive consequences of protecting the production equipment. Therefore, these chemicals and catalysts do not qualify for the manufacturing exemption.[147]

Listed Support Equipment. This equipment automatically qualifies for the exemption if it is used to power, supply, support or control equipment that qualifies for exemption or to generate electricity, chilled water or steam for ultimate sale:

- actuators
- steam production equipment and its fuel
- in-process flow through tanks
- cooling towers
- generators
- heat exchanges
- electronic control room equipment
- computerized control units
- compressors
- and hydraulic units.[148]

Beginning October 1, 1999, the exemption extends to these items, as well:

- transformers and the switches, breakers, capacitor banks, regulators, relays, reclosers, fuses, interrupters, reactors, arresters, resistors, insulators, instrument transformers and telemetry units that are related to the transformers;
- pumps; and
- transformers located at an electric generating facility that increase the voltage of electricity generated for ultimate sale, the electrical cable that carries the electricity from the electric generating equipment to the step-up transformers and the switches, breakers, capacitor banks, regulators, relays, reclosers, fuses, interrupters, reactors, arresters, resistors, insulators, instrument transformers and telemetry units that are related to the step-up transformers; and transformers that decrease the voltage of electricity generated for ultimate sale and the switches, breakers, capacitor banks, regulators, relays, reclosers, fuses, interrupters, reactors, arresters, resistors, insulators, instrument transformers and telemetry units that are related to the step-down transformers.

[146] Comptroller Letter No. 9612121L (Kevin Koller, December 11, 1996).
[147] Comptroller Letter No. 9612121L (Kevin Koller, December 11, 1996).
[148] H.B. 1855, § 1 (75th Leg., R.S.) amending Texas Tax Code § 151.318, "Property Used in Manufacturing".

Back to Table of Contents

Lubricants. The 1999 Legislation reinstated the manufacturing exemption for lubricants, chemicals, chemical compounds, gases or liquids used or consumed during the actual manufacturing, processing or fabrication of tangible personal property for ultimate sale if their use or consumption is necessary and essential to prevent the decline, failure, lapse or deterioration of exempt manufacturing equipment.
Gases.

The 1999 Legislation reinstated the manufacturing exemption for gases used on the premises of a manufacturing plant to prevent contamination of raw materials or products, or to prevent a fire, explosion, or other hazardous or environmentally damaging situation at any stage in the manufacturing process or in loading or storage of the product or raw material on premises.

Example. In the course of repairing oil refinery equipment, inert gas is piped in to displace oxygen in order to prevent fires or an explosion. The inert gas may be purchased tax-exempt.

Quality Control Process. The 1999 Legislation reinstated the manufacturing exemption for tangible personal property used or consumed during the actual manufacturing, processing or fabrication of tangible personal property for ultimate sale if the use or consumption of the property is necessary and essential to a quality control process.

Example. Spectrometers used to test the composition of chemicals produced for ultimate sale.

Safety Clothing. The 1999 Legislation reinstated the manufacturing exemption for safety apparel or work clothing that is used during the actual manufacturing, processing or fabrication of tangible personal property for ultimate sale if the manufacturing process would not be possible without the use of the apparel or clothing and the apparel or clothing is not resold to the employee.

Examples. Hardhats, earplugs, hairnets, safety shoes, mouth coverings, bunny suits.

Public Health. The 1999 Legislation reinstated the manufacturing exemption for tangible personal property used or consumed in the actual manufacturing, processing or fabrication of tangible personal property for ultimate sale if the use or consumption of the property is necessary and essential to comply with federal, state or local laws or rules that establish requirements related to public health.

Caution. OSHA-required items only qualify for the manufacturing exemption if they're used in the actual manufacturing of the product for sale and they are necessary and essential to comply with regulations.[149]

Water Conservation. The 1999 Legislation reinstated the manufacturing exemption for tangible personal property specifically installed to:

- reduce water use and wastewater flow volumes from the

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[149] See, e.g., Tax Policy News, November 2002 and Comptroller Decision No. 38,348 (Aug. 21, 2002) (deciding that an OSHA-required eyewash system didn't qualify for the manufacturing exemption because it wasn't used or consumed in the manufacturing process).

manufacturing, processing, fabrication or repair operation;

Example. The cost of redesigning and rebuilding a machine so that it will use less water. reuse and recycle wastewater streams generated within the manufacturing, processing, fabrication or repair operation; or treat wastewater from another industrial or municipal source for the purpose of replacing existing freshwater sources in the manufacturing, processing, fabrication or repair operation.

Note. The pollution control exemption already covers much of this equipment. This provision extends the exemption to cover equipment that treats wastewater from a source other than the taxpayer.

No Divergent Use. The water conservation exemption applies only if the equipment or services are used solely for the exempt purpose.

Increased Capacity in a Petrochemical Refinery or Chemical Plant. Labor is exempt as new construction when the repair, restoration, remodeling or modification of an improvement to a manufacturing or processing production unit in a petrochemical refinery or chemical plant provides increased capacity in the production unit.[150]

Pollution Control Equipment. Machinery or equipment required by law or regulation to control pollution resulting from the manufacturing process also qualifies for the exemption.[151]

[150] *See* Comptroller Rule §3.362.
[151] Texas Tax Code § 151.338.

Example. Pollution control equipment required by regulatory authorities in connection with particular manufacturing processes, such as fuel blending operations, is exempt. The electricity used to power the equipment is also exempt.[152]

Non-Qualifying Items. By statute, many items will not qualify for the manufacturing exemption, even if they directly touch the product or cause a chemical or physical change to the product being manufactured for sale.

Indirect Equipment. The manufacturing sales tax exemption applies only to equipment that is directly used or consumed in manufacturing, processing or fabricating tangible personal property for ultimate sale.[153] The equipment must directly make or cause a chemical or physical change to the preliminary, intermediate or final product being manufactured for ultimate sale.

Intraplant Transportation Equipment. This equipment is used to move, without change, products in process in the manufacturing plant. This equipment and machinery, by statute, does not qualify as manufacturing equipment. This includes equipment such as

[152] Taxability Ruling 1275 (John Sharp, October 18, 1991), STAR No. 9110T1221D05.
[153] October 1, 1997. *cf.* Sharp v. Tyler Pipe Indus., Inc., 919 S.W.2d 157 (Tex. App. – Austin 1996).

Back to Table of Contents

conveyor belts, pipelines, forklifts, etc.[154]

Example. Electricity used to transport product (e.g., propylene and butadiene) within a plant facility is taxable intraplant transportation. Transporting blended product from tanks and loading it into rolling stock, barges or tankers is also transportation. Equipment and electricity used to transport and load the product is taxable.[155]

Exception for Recirculation. Piping qualifies if it is piping through which the product (or an intermediate or preliminary product that will become an ingredient or component part of the product) is recycled or circulated in a loop between the single item of manufacturing equipment and the ancillary equipment that supports only that single item of manufacturing equipment, if the single item of manufacturing equipment and the ancillary equipment operate together to perform a specific step in the manufacturing process.

Comptroller Hearing No. 44,231 considered whether a natural gas producer's purchases qualified for the manufacturing exemption. The administrative law judge determined that compressors used to bring natural gas to the surface did not qualify for the exemption because the compressors were used before any chemical or physical changes were made to the item being manufactured for sale. The manufacturing exemption applies only to equipment used during the manufacturing process. Therefore, compressors used to extract oil and gas from the ground and to increase pressure for transportation purposes are not exempt. Compressors necessary for operating field dehydrators, heat treaters, separators and scrubbers qualify for the exemption because they are used in processing the natural gas and involve a chemical or physical change to the item being manufactured for sale. Since the compressors didn't qualify for exemption, the administrative law judge also denied exemptions for compressor repairs and maintenance and purchases of lubricants, soap and surfactants for the compressors.[156]

The hearing also considered whether various oil and gas services were taxable. The invoice descriptions of the services performed were integral in the determination of whether the various services were taxable.

Property Repairs. Manufacturing includes repairing or rebuilding tangible personal property for the purpose of being sold, but does not include the repair or rebuilding of property belonging to another.[157]

Maintenance Excluded. The manufacturing process does not include maintaining the life of tangible personal

[154] Before October 1, 1997, equipment purchased for intraplant transportation of products may qualify for the manufacturing exemption if some physical or chemical change occurs during the transportation. *cf.* Chevron Chemical v. Sharp, 924 S.W. 2d 429 (Tex. App. – Austin 1996, writ denied).

[155] Taxability Ruling 1275 (John Sharp, October 18, 1991), STAR No. 9110T1221D05.

[156] *See also* Comptroller Hearing No. 43,112 (considering whether chokes, manifolds, valves and related items qualified for the manufacturing exemption).

[157] Comptroller Rule 3.300(a)(9).

Back to Table of Contents

property after the completion of manufacturing.[158]

G. Opportunities and Pitfalls.

Manufacturers should be alert to these issues dealing with the manufacturing exemption:

Equipment Repairs and Overhauls. Repairs, overhauls and other taxable services performed on manufacturing equipment are exempt from sales tax.

Note. This includes manufacturing equipment which was purchased before the manufacturing exemption became law. For example, repairs to manufacturing machinery purchased in 1975 are nonetheless exempt, even though there was no manufacturing exemption in 1975.

Product Services. Taxable services performed directly on the product being manufactured prior to its distribution for sale and for the purpose of making the product more marketable are exempt from sales and use tax.

Leased Equipment. Any manufacturing equipment leased or rented for more than one year is entitled to the exemption. The one-year period is taken literally. Therefore, the Comptroller believes that a lease for a term of one year, even if it has month-to-month renewals after that term, will not be entitled to the exemption.

Example. Compressor Rentals. A Comptroller letter considered whether compressors rented for use in processing oil and gas qualified for the manufacturing exemption.[159] Rental equipment, including compressors, qualifies for the manufacturing exemption only if it is rented for one year or longer. If the compressor breaks down prior to the end of the one-year rental contract, it still qualifies for the exemption. However, the exemption is lost if there is no written contract. Similarly, if the rental contract is not renewed in writing for a term of one year or longer, subsequent rental payments will subject to tax. Entering into a subsequent agreement to extend the lease will not retroactively exempt month-to-month lease payments that have already occurred prior to the renewal.

Lump-Sum Construction Contracts. The manufacturer must be the purchaser of the equipment. Recall that contractors who purchase materials under a lump-sum construction contract are considered the consumer of all materials purchased for the job. Therefore, if a contractor is constructing a manufacturing complex under a lump-sum contract, the contractor, and not the manufacturer, is the purchaser of the manufacturing equipment. The manufacturing exemption is lost simply because the contract did not separately state the charge for materials and labor. Once it is lost, it can never be regained.

Real Property. The exemption is only available for personal property. It is not available for real property. While this is rarely an issue when the equipment is initially purchased, it can affect whether or not repairs of the equipment will be exempt after installation. If the equipment is so affixed to the real estate that it loses its character as personal

[158] Comptroller Rule 3.300(a)(9).

[159] Comptroller Letter No. 200102379L.

property and becomes a fixture to the real property, the exemption is lost and all subsequent repairs will be considered taxable repair and remodeling of commercial real property. To avoid this, a manufacturer should ensure that the equipment is carried on its books as personalty and not realty. Furthermore, the manufacturer should be able to show how the equipment could be moved to a new site if needed. The mobility of the property can affect its status as personalty.

Manufacturers who Install. Contractors who consume tangible personal property while improving real estate aren't eligible for the manufacturing exemption.[160] The Comptroller treats manufacturers who install items of tangible personal property or real property as contractors for sales and use tax purposes.[161] The Comptroller requires the manufacturer/installer to pay sales tax on its purchases. If the manufacturer previously purchased equipment under a manufacturing exemption, the Comptroller requires the manufacturer to treat as a divergent use, the use of the equipment for jobs including installation.[162] The Comptroller's position is that it makes no difference whether the manufacturer performs the work as part of a lump-sum contract or a separated contract.

Divergent Use. Taxpayers are required to accrue use tax on the fair value of non-qualified use of manufacturing equipment. Prior to October 1, 2001, taxpayers could not claim a partial manufacturing exemption. The item was either exempt or it was not exempt.[163] Once the divergent use occurred, the taxpayer owed sales and use tax on the fair rental value of the equipment. After October 1, 2001, Texas taxes the amount of divergent use during the first four years of owning the equipment.[164] However, no tax is due on divergent use if the first divergent use occurs after the first four years or doesn't exceed 5% of the total use of the item.

Example. Matrix Mud Company manufactures custom chemical blends of oil-based mud. When it purchases or builds new mixing plants and storage tanks for finished goods, Matrix selects designs that allow for independent mixing in each tank. All of Matrix's

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160 H.B. 2424 (78th Legis. Session) (amending Texas Tax Code § 151.056).

161 Comptroller Decision No. 41,339 (Sept. 13, 2002) (stating that a manufacturer of signs lost its manufacturing exemption when it began providing installation services).

162 In Comptroller Decision No. 41,339 (Sept. 13, 2002), the Comptroller refused to allow a credit for taxes that the taxpayer had "erroneously" collected from its customers. Instead, the Comptroller stated that Tax Code § 111.016 requires the manufacturer/installer to remit all tax it collected in error, plus the additional tax assessed on the purchase of materials and the divergent use of equipment. The Comptroller will refund or credit the "erroneously" collected tax only after the taxpayer reimburses the tax to its customers.

163 Texas Tax Code § 151.3181. (effective Sept. 1, 2001)

164 Texas Tax Code § 151.3181 (effective Oct. 1, 2001).

large storage tanks are fitted with jets, suctions and discharges to allow mixing action. To expedite manufacturing, Matrix mixes basic blends and stores these unfinished products in the storage tanks. When it receives an order from a customer for specific chemical properties, Matrix adds materials to the basic blends in the storage tanks and the tanks are used to finish blending. These tanks vary in size, and can be less than 500 barrels or greater than 500 barrels.[165]

The Comptroller generally treats aboveground storage tanks with a capacity of more than 500 barrels as improvements to real property unless there is other evidence, such as a contract or an agreement, that the tanks are tangible personal property. Aboveground tanks that have the capacity of 500 barrels or less are treated as tangible personal property.

Matrix's tanks are used for both storage (divergent use) and mixing (exempt use). Matrix may claim an exemption on the tanks that remain tangible personal property, but must accrue tax on the divergent use.166 Storage tanks that are in excess of 500 barrels are improvements to realty. A manufacturer, who purchases tanks that would qualify for the manufacturing exemption (i.e., directly makes or causes chemical or physical change to product for ultimate sale) but are incorporated to become improvements to realty, may issue an exemption certificate for the separately-stated charges for parts that actually process the product (i.e., jets, suctions and discharges) and that are sold under a separated contract.[167] The manufacturer may claim an exemption on the other materials, but must accrue tax based on divergent use of those materials.

If the stairs and railings are added to tanks that have capacity in excess of 500 barrels when the tanks are first installed to put into service, then the work is new construction finish-out and the terms of the contract will determine the party responsible for tax on the materials.

Once the storage tanks become improvements to realty, modifications (i.e., adding stairs and rails) to nonresidential improvements to real property are taxable. Maintenance performed on nonresidential improvements to real property is taxable unless it qualifies as scheduled and periodic maintenance under Rule 3.357.

Storage tanks that are exceed 500 barrels in capacity used solely to store raw materials or finished products do not qualify for the manufacturing exemption.

H. Exemption for Items Used to Capture, Transport and Sequester Carbon Dioxide (CO_2).

Texas law exempts from sales and use tax components of tangible personal property used in connection with an advanced clean energy project that are installed to capture, transport, inject or

165 *See* Comptroller Taxability Ruling No. 200301709T (January 30, 2003).

166 *See* Comptroller Rule 3.300. Divergent use of the equipment that occurs prior to October 1, 2001 is taxable based on the fair market rental value of the equipment for the period of taxable use. Divergent use of manufacturing equipment used on or after October 1, 2001 is taxed in the manner set out under Texas Tax Code § 151.3181. *See* Comptroller Rule 3.300(k).

167 *See* Comptroller Rule 3.300(i).

prepare for transportation or injection of CO_2 from an anthropogenic emission source. The CO_2 must be sequestered in Texas as part of an enhanced oil recovery project under conditions that create a reasonable expectation that at least 99% of the CO_2 will remain sequestered from the atmosphere for at least 1,000 years.[168]

I. Gas and Electricity Exemption.

The purchase of gas or electricity may be exempt from sales tax, depending upon whether the use is qualified.

Qualified Uses Applying to the Oil & Gas Industry. Taxpayers may exempt gas and electricity if it is used:

- Manufacturing. Processing tangible personal property for sale as tangible personal property;169
- Mining. Exploring for, or producing and transporting a material extracted from the earth. This includes materials such as coal, oil, natural gas or coal slurry.

However, sales or use tax is due on natural gas or electricity used to transport a product which was manufactured from a material extracted from the earth;

Electrical processes. This includes electroplating, electrolysis and cathodic protection.

[168] House Bill 469 (Effective Sept. 1, 2009).

[169] Electricity may be exempt if a restaurant uses it predominately in manufacturing or processing the food. However, further cooling or freezing of products isn't exempt. Comptroller Decision No. 39,093 and 39,8707 (May 2, 2001).

Example. Petrochemical storage and distribution facilities may claim an exemption for electricity used in pumping product into a blending tank if the product being pumped into the tank is a material or its component extracted from the earth. Blending various products for the production of special types of fuel is considered nontaxable processing. However, the electricity would be taxable if the product contained substances which did not exist in nature or were not components of the material extracted from the earth.[170]

Electricity to transport a blended or processed product is taxable, while electricity used to transport a material extracted, prior to processing, blending, etc., from the earth (oil, gas, sulphur, water, etc.) is an exempt use.

Example. Mixing feed stock of various petroleum products and blending them with additives to manufacture specific products requested by a customer is also considered processing. The electricity used to power blending pumps, which directly blend the products is exempt.[171]

Example. The electricity used in the initial refrigeration to "chill" petroleum products, such as propylene and butadiene, is exempt. However, subsequent refrigeration of the "chilled" products is taxable (e.g., keeping the product chilled in the holding tank).[172]

[170] Taxability Ruling 1275 (John Sharp, October 18, 1991), STAR No. 9110T1221D05.

[171] Taxability Ruling 1275 (John Sharp, October 18, 1991), STAR No. 9110T1221D05.

[172] Taxability Ruling 1275 (John Sharp, October 18, 1991), STAR No. 9110T1221D05.

Example. Natural gas used in blending and refrigeration operations to burn recovered vapors (as part of pollution control) resulting from the blending process and from the initial refrigeration to "chill" the products is exempt. Natural gas used to burn recovered vapors resulting from storage refrigeration and any other nonprocessing operations is not exempt.[173]

Non-Qualifying Uses. Non-qualifying use means the use of gas and electricity by a person engaged in selling, warehousing or distributing a commodity or performing a professional or personal service. This includes electricity or gas used in the wholesale and retail trades, hotels, office buildings, in preparing or storing food for immediate consumption and for use by persons providing taxable services.

Taxable v. Exempt Uses. When determining the predominant use of natural gas or electricity, utilities used to operate production machinery and for lighting, cooling and heating in the manufacturing area are considered exempt uses. Gas and electricity used to operate, lighting, cooling and heating in manufacturing support areas are considered taxable uses. Manufacturing support areas include, but are not limited to, storage, engineering, office and accounting areas, research and development and break room, eating and restroom facilities. Utilities used in an area open to the public for purposes of marketing a product ready for sale are considered taxable uses. Utilities used to operate other nonproduction machinery or equipment are taxable.

[173] Taxability Ruling 1275 (John Sharp, October 18, 1991), STAR No. 9110T1221D05.

Single Meters and "Predominant Use." Natural gas or electricity used for both exempt and taxable purposes under a single meter is totally exempt or totally taxable based upon the "predominant use" of the gas or electricity measured by that meter. Predominant use of gas and/or electricity for exempt purposes is required to obtain an exemption.
Utility Study Required. If the utilities are not separately metered, the Comptroller requires the taxpayer to have an engineer perform a utility study to establish the qualified, predominant use of the utilities. The study must list all exempt and nonexempt uses of the utilities, as well as other technical specifications. The business owner must certify that all items using natural gas or electricity are listed and the hours of use for each item are correct. The electricity or natural gas computations must be performed by a registered engineer or a person with an engineering degree from an accredited engineering college. The taxpayer must complete the utility study and have it on file at the time the taxpayer submits the exemption certificate to the utility company. Without the study, the Comptroller presumes the exemption is invalid.

Example. Comptroller Rule 3.295 requires a predominant use study to include all items on a particular meter and all utility uses for each item. Limiting the analysis only to a portion of the use (e.g., refrigeration) results in an incomplete study. A taxpayer claiming exemption must present evidence that clearly brings him within the exemption.[174]

[174] Taxability Ruling 1275 (John Sharp, October 18, 1991), STAR No. 9110T1221D05.

Back to Table of Contents

No Study. Persons obtaining a sales tax refund without a valid study will be assessed tax, penalty and interest on the full amount of the refund, if the exemption is not proved. The Comptroller may request a copy of the study for review before or after the sales tax exemption is granted. Review of the study by the Comptroller does not confirm the study's accuracy.

What if Qualifying Use is 50% or Less? If 50% or less of the electricity or gas flowing through a single meter constitutes a qualified (exempt use), none of the electricity or gas is exempt. However, the taxpayer may add another meter through which the qualifying use electricity or gas may flow which will then allow the exemption for the gas or electricity flowing through the second meter (assuming more than 50% of the use flowing through the second meter is qualified.) According to the Comptroller's office, this strategy is allowed.

Non-qualifying Property. The following items don't qualify for the manufacturing exemption:[175]

- Property used in the transmission or distribution of electricity;
- Transformers, cable, switched, breakers, capacitor banks, regulators, relays, reclosers, fuses, interrupters, reactors, arresters, resistors, insulators, instrument transformers and telemetry units that are not otherwise exempted; and
- Lines, conduit towers and poles.

Caution: The Comptroller requires a business with more than one location to have a valid utility study for each location, even if the gas and electricity use at the various locations are comparable.[176]

Drilling Equipment. Drilling equipment includes the drilling rig and its components (e.g., blow out preventers, mud pumps, mud tanks, draw-works, swivel, kelley, drill collars, drill bits and drill pipe.) The Comptroller doesn't consider peripheral equipment to be drilling equipment when it is not attached to the drilling rig, but utilized during the drilling process.

Well servicing equipment used inside the wellbore may be deemed drilling equipment if it can only be used during the drilling of an oil or gas well.[177]

J. Common Property Ownership Transfers.

This is historically called "the drill pipe rule" because the rule originated during the oil boom when commonly-owned limited partnerships were transferring oil & gas drilling equipment among themselves for credits on the joint interest billings. Sales of tangible personal property are not subject to sales tax if the purchaser owns a joint or undivided interest in the property with

[175] Tax Code § 151.318 (c)(5).

[176] Comptroller Hearing No. 39,602 (June 27, 2002).

[177] Comptroller Letter No. 201009035L.

the seller, either before or after the sale.[178]

Opportunities and Pitfalls. Closely-held companies often organize one entity to own and maintain the equipment. The affiliates make periodic equipment rental payments to the equipment-holding entity for use of the equipment. Generally, the rental payments would be taxable as the rental of tangible personal property. The closely-held companies may be able to use this rule to solve this dilemma. In order to show that the transfers of tangible personal property (e.g., belts and fittings) are exempt under the "drill pipe" rule, a taxpayer must be able to provide documents showing common ownership of the property after the sale (e.g. a copy of the contract for the well listed on the invoice). The taxpayer must also be able to show that the purchaser paid tax when it purchased the item (e.g. a copy of the original purchase invoice, or printouts from the accounting or inventory system showing that tax was paid).

[178] Comptroller Rule 3.331 *and* Texas Tax Code § 151.306. *See also* Texas Tax Code § 151.348 (exempting certain transactions between members of cooperative research and development joint ventures) and Comptroller Decision No. 38,891 (June 14, 2002) (determining that a sale of software to a participant of a joint venture that developed the software was not subject to sales and use tax).

K. Water-Related Exemptions.

Texas law exempts from tax certain water-related equipment, supplies and services:

- Rainwater harvesting, equipment or supplies, water recycling and reuse equipment or supplies, or other equipment, services or supplies used solely to reduce or eliminate water use;
- Equipment, services, or supplies used solely for desalination of surface water or ground water;
- Equipment, services or supplies used solely for brush control designed to enhance the availability of water;
- Equipment, services, or supplies used solely for precipitation enhancement (e.g. cloud seeding);
- Equipment, services or supplies used solely to construct or operate a water or wastewater system certified by the TCEQ as a regional system;
- Equipment, services or supplies used solely to construct or operate a water supply or wastewater system by a private entity used as a public-private partnership as certified by the political subdivision that is a party to the project; and
- Tangible personal property specifically used to process, reuse or recycle wastewater that will be used in fracturing work performed at an oil or gas well.[179]

Example. Fracturing at an oil or gas well. Production and completion require fracturing, which requires injecting a large volume of fresh water into the well to fracture rock formations and release the oil or gas. Recycling and reusing the

[179] Texas Tax Code § 151.355.

Back to Table of Contents

recovered contaminated wastewater reduces the amount of fresh water used in oil and gas drilling.[180]

Equipment and supplies specifically used to process, reuse or recycle the wastewater resulting from the fracturing at an oil or gas well qualify for sales tax exemption under Texas Tax Code § 151.355.

L. Production/Severance Tax Exemptions.

Three-year inactive well exemption. Texas law provides a ten-year exemption from severance tax for oil and gas produced from a well certified by the RRC as a three-year inactive well.[181]
Taxpayers seeking to claim the exemption must first obtain certification from the RRC that the well has been inactive for the three years prior to the date the taxpayer applies for the tax exemption. After certification from the Commission, the taxpayer must apply to the Texas Comptroller of Public Accounts to qualify for the tax exemption.

The exemption will extend for ten years and beginning with the date of the Commission's certification. Qualifying taxpayers are exempt only from the severance tax and must still report and pay the Regulatory Tax and the Oil-Field Cleanup Regulatory Fee.

Taxpayers who pay tax after the certification date, may recover the tax by filing amended reports. However, taxpayers must apply for the credit within one year of the date the Commission certifies the well as a three-year inactive well.[182]

Two-year inactive well exemption. Texas law also provides a ten-year exemption for oil or gas produced from a well that has been certified by the Texas RRC as a "two-year inactive well."[183] In spite of the name, a well may have one month of production during the two-year period and remain eligible for the exemption.[184]

TERRA Exemption. Until 2003, Texas law exempted from oil production tax hydrocarbons produced from a Texas Experimental Research and Recovery Activity well.[185]

Enhanced Oil Recovery Project. Producers producing crude oil from an enhanced oil recovery project may claim an exemption from oil production tax. The enhanced oil recovery project must be approved and certified by the Texas RRC. The operator must also apply to the Comptroller for the exemption. Moreover, the operator is responsible for advising the Comptroller whenever the status of the enhanced oil recovery project changes in a manner that would affect the imposition of the tax due on the oil produced from the project area.[186]

Incremental Production Well Exemption. Effective September 1, 1997, leases with wells averaging seven barrels of oil equivalent (BOE) a day or less in 1996 were eligible for a 50% tax reduction on incremental production.

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180 Comptroller Letter No. 201106111L.

181 Tax Code §§ 202.056 (a)(3) *and* 201.058.

182 Comptroller Crude Oil Bulletin (October 5, 1993), STAR No. 9310L1274E12.

183 Tax Code §§ 202.056 (a)(4) *and* 201.058.

184 Comptroller Memo, STAR No. 9908649L.

185 *See* Texas Tax Code § 202.059. *See also* Comptroller Rules §§ 3.32 *and* 3.38.

186 *See* Comptroller Rule § 3.37.

The 50% reduction extended for five years. The exemption remained active as long as the price of oil, as judged by the Comptroller's office, remained below $25 (adjusted to 1997 dollars). The incremental production well exemption is expended when the price of oil reaches $25 or above for three consecutive months and is reinstated when the price of oil drops below $25 for three consecutive months.

The exemption included crude oil production taxes but did not include the oil field cleanup fee or the regulatory fee.

Flared/Released Casinghead Gas Exemption. This exemption applies to only the casinghead gas recovered from the vapor recovery unit on a lease. The casinghead gas will be exempt from severance taxes. Any other casinghead gas produced will be taxable.

Exemption of Oil Incidentally Produced in Association with the Production of Geothermal Energy. The Comptroller requires operators to provide listed information for each qualifying oil well showing it produces less than 10 barrels of oil per day for a three-month period.[187]

Diesel Fuel Tax Exemption for Water, Fuel Ethanol, Biodiesel, Renewable Diesel, and Biodiesel and Renewable Diesel Mixtures. The Comptroller requires an IFTA licensee who overpays the tax on a water-based diesel fuel, ethanol blended diesel fuel, biodiesel, renewable diesel, biodiesel blend, or renewable diesel blend to request a refund from the Comptroller by way of an IFTA tax return.[188]

The Agricultural Code redefined biodiesel fuel and renewable diesel fuel in 2009, exempting from the state diesel fuel tax renewable diesel fuel and the volume of renewable diesel fuel blended with taxable petroleum diesel fuel.[189]

Biodiesel fuel is motor fuel that: (1) meets the U.S. Environmental Protection Agency registration requirements for a fuel or fuel additive, (2) is mono-alkyl esters of long fatty acids derived from vegetable oils or animal fats, (3) meets the ASTM specification D-6751, (4) is intended for use in engines designed to run on conventional diesel fuel and (5) is derived from agricultural products, recycled greases, biomass, or animal fats or the waste products of those products or fats.

Renewable diesel fuel is motor fuel that: (1) meets the U.S. Environmental Protection Agency registration requirements for a fuel or fuel additive, (2) is a hydrocarbon, (3) meets the ASTM specification D-975, (4) is intended for use in engines designed to run on conventional diesel fuel and (5) is derived from agricultural products, recycled greases, biomass, or animal fats or the wastes products of those products or fats. Renewable diesel fuel and blends of renewable diesel fuel must meet the same storage tank, sales invoice and retail pump labeling requirements of biodiesel fuel.

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187 House Bill 4433 (Effective Sept. 1, 2009) *and* Comptroller Rule 3.32. (filed July 29, 2011).

188 Comptroller Rule 3.443 (filed July 29, 2011).

189 House Bill 2582 (Effective June 19, 2009). Renewable diesel fuel is included in the Fuel Ethanol, Biodiesel Fuel, and Renewable Diesel Production Incentive Program administered by the Texas Department of Agriculture.

Exemption of Gas Incidentally Produced in Association with the Production of Geothermal Energy. . The Comptroller requires operators to provide listed information for each qualifying oil well showing each lease produces less than 60 mcf of gas per production day for a three-month period.[190]

Reduced Tax Rate Exemption for High-Cost Wells. Texas law provided for a reduced tax rate exemption for high-cost wells, which included wells spudded or completed after August 31, 2002, and before September 1, 2010. Refund claims may be available for those exemptions arising prior to the four-year statute of limitations period.

Applying for an exemption. Taxpayers must provide the following information in an exemption application:

- Lease or well name as documented by the Texas RRC
- County of production
- Texas RRC District
- Lease identification number assigned by the Texas RRC
- Date Texas RRC certified the well for the exemption (need Texas RRC certification letter)

Documents required. The types of documents required vary depending on the type of exemption sought:

- Three-year inactive well exemption
- Texas RRC certification letter
- Two-year inactive well exemption
- Texas RRC certification letter
- Texas RRC certification letter
- Enhanced oil recovery project
- Texas RRC Enhanced Oil Recovery Project and Area Designation Approval and
- Either the Certificate of Positive Production Response or
- Proof that incremental production has occurred (for an expansion)
- Incremental production well exemption
- Texas RRC certification letter
- Flared/released casinghead gas exemption
- Texas RRC certification letter

M. Oil Production Tax Exemptions.

The oil production tax is imposed at 4.6% of the market value of oil. This rate is reduced if certain exemptions apply:

Reduced Oil Production Tax Rates for Certified Exemptions:

- Enhanced Oil Recovery Exemption (EOR) = 2.3% of market value of oil
- Incremental Production Exemption = 2.3% of market value of oil
- Co-Production Project Exemption = 2.3% of market value of oil
- Three-Year and Two-Year Inactive Well Exemptions = 0% of market value of oil.

Other taxes and fees. The exemptions generally do not apply to other state taxes and fees. In addition to the oil production tax, Texas imposes the regulatory tax at the rate of 3/16 of a cent ($.001875) per barrel and the regulatory fee at the rate of 5/8 of a cent ($0.00625) per barrel. The rate was 5/16 of a cent ($.003125) per barrel for report periods prior to September 2001.

[190] House Bill 4433 (Effective Sept. 1, 2009)*and* Comptroller Rule 3.24 (filed July 29, 2011).

Exemption for Enhanced Recovery Projects Using Anthropogenic Carbon Dioxide. In 2007, the Texas legislature established a tax exemption for Enhanced Recovery Projects Using Anthropogenic Carbon Dioxide.[191] The original bill provided a seven- year exemption period. In 2009, the legislature extended that exemption period to 30 years.[192]

N. Natural Gas Tax Exemptions.

Reduced gas production tax rates are available for certified exemptions, including:

- Incremental Production Exemption (3.75% of market value of gas);
- 3-Year and 2-Year Inactive Well Exemptions (0% of market value of gas);
- Co-Production Project Exemption (0% of market value of gas);
- High-Cost Gas Exemption (0% of market value of gas);
- High-Cost Gas Reduced Tax Rate (0% to 7.4% of the market value of gas) and Flared Gas Exemption (0% of market value of gas).

The rate varies by well depending on how the well's drilling and completion costs compare to the median cost of all High-Cost gas wells during the previous State fiscal year.

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191 80th Legislature, Regular Session.
192 House Bill 469 (Effective Sept. 1, 2009).

Chapter IV. Oil and Gas Severance Tax

A. Introduction

Texas imposes a tax on the production of oil and gas in this state. The oil and gas production taxes are commonly referred to as severance taxes because they are measured based upon market value of the oil or gas at the time it is severed from the wellhead.

B. Oil Production Tax.

Texas imposes a tax on the production of oil.[193] The tax is imposed at the rate of 4.6 percent of the market value of oil produced in this state or 4.6 cents for each barrel of 42 standard gallons of oil produced in this state, whichever rate results in the greater amount of tax.[194] The market value of oil is the actual market value plus any bonus, premium, or other consideration paid for the oil.[195]

Who Pays? The tax is imposed on the "first purchaser" of oil. However, the Comptroller may provide persons other than the first purchaser, such as a producer or an operator, written authorization to remit the tax. Texas law defines a "first purchaser" as a person who purchases crude oil from a producer. A "producer" is a person who takes oil from the earth or water in any manner, a person who owns, controls, manages, or leases an oil well, or a person who owns an interest, including a royalty interest, in oil or its value, whether the oil is produced by the person owning the interest or by another on his behalf by lease, contract, or any other arrangement. A first purchaser pays the tax imposed by this chapter on oil that the first purchaser purchases from a producer and takes delivery on the premises where the oil is produced.

Reporting and Recordkeeping Requirements. The reporting and recordkeeping requirements vary for the various parties involved in the transaction:

- First Purchaser. The first purchaser is the first person who purchases crude oil directly from a producer or operator. The first purchaser must remit the tax due on all oil purchased from operators or producers when delivery is made on the lease. The operator or producer must remit the tax on all other oil removed from the lease.
- Operator. An operator is the person responsible for the actual physical operation of the oil producing property. The operator is generally responsible for reporting, or accounting for, all of the production from the property.
- Producer. A producer is anyone who owns an interest in the property, including a

Tax ID number required. A first purchaser may not take delivery of crude oil from an operator or producer unless the operator or producer furnishes the purchaser with a taxpayer identification number assigned by the Comptroller. A first purchaser failing to secure the producer's taxpayer number, either from the producer or the Comptroller, will be liable for any tax, penalty, and interest

[193] Texas Tax Code § 202.051.
[194] Texas Tax Code § 202.052.
[195] Texas Tax Code § 202.053.

due on the oil purchased from the producer or operator.

Joint Liability. The Comptroller may provide persons other than the first purchaser written authorization to remit tax. Upon written request based upon an agreement by the operator and all producers and purchasers involved, the Comptroller may authorize a producer or a subsequent purchaser to report and remit the tax. The authorization will be for the purpose of reporting and remitting tax only. If the authorized party fails to pay the tax the producer, first purchaser, or any subsequent purchaser remain liable for the tax.

All crude oil produced in Texas is taxable. The first purchaser is required to withhold the tax and remit it to the Comptroller if delivery is made on the lease. All purchasers are liable until the tax is paid regardless of where possession takes place. All oil transactions between first purchasers and producers must be reported on the crude oil purchaser's monthly tax report.

Example. Skim oil purchased from a producer should be reported and the tax should be deducted and remitted by the purchaser. Skim oil purchased from anyone other than the producer, should not be reported; however, the purchaser incurs a liability if the tax has not been paid.[196]

Example. Frac oil purchased from a gatherer should not be reported because it is not a "first purchase."[197]

[196] Comptroller Letter No. 8401L1076D03 (G.C. Edgar, January 30, 1984).
[197] Comptroller Letter No. 8401L1076D03 (G.C. Edgar, January 30, 1984).

C. Natural Gas Production Tax.

Texas imposes a tax on the production of natural gas in this state.198 The production tax is due on the first sale of the gas production. Additional tax is not due on gas purchased from outside parties.

Rate. The tax is imposed at the rate of 7.5 percent of the market value of gas produced and saved in this state by the producer.[199]

Application. All gas produced is taxable except:

- Gas injected into the earth, unless sold for such purpose.
- Gas produced from oil wells with oil and lawfully vented or flared.
- Gas used for lifting oil, unless sold for such purpose.
- Legislative and governmental tax exemptions.

Example. Taxpayers who inject the gas for pressure maintenance purposes are entitled to exempt a like substance upon recovery.

Joint Liability. First purchasers are primarily liable for the tax. However, subsequent purchasers may also be required to pay the tax if it has not already been paid.

Example. Condensate purchased from producers is reportable on the natural gas purchaser's monthly tax report. The taxable value is the prevailing price in the area where recovered. The purchaser must determine if the transaction is with a

[198] Texas Tax Code § 201.051.
[199] Texas Tax Code § 201.052.

Back to Table of Contents

producer of the condensate or with another party. Although the purchaser may be a subsequent purchaser, there is a liability if the tax has not been paid.[200]

Taxable Value. Tax is imposed on the market value at the wellhead. If gas is sold for cash at or near the wellhead, the taxable value equals the producer's gross receipts. Reimbursed severance taxes should not be included in calculating the gross receipts.

If the consideration for the sale includes a portion of all products and/or residue of the gas, then the gross value of the gas shall be all things of value received in consideration for the gas.

Marketing costs that the producer after September 1, 2005, incurs after normal lease separation may be deducted from the gross receipts to determine the net taxable value. Production costs are not deductible.

The use tax for raw gas used on the lease shall have the same taxable value as gas sold from the lease. Available residue gas, which is returned and used on the lease shall have the same value the producer would have received for the residue gas if the producer had sold the gas.

What if there are no gas sales on the lease site? If gas is produced and used on a lease from which there are no gas sales, the taxable value is the prevailing market value of comparable gas in the same general area.

If there is no comparable gas in the area, taxpayers should report the tax based on the county average gas prices published by the Comptroller's office.

Example. The price being paid for gas on a lease includes 100% reimbursement for the Texas severance tax. The taxable value should be determined by subtracting any marketing costs claimed from the total value received and dividing the result by 1.075.[201]

Assuming no marketing costs and using September 1982 figures, the taxable value would be $5.877388. (6.318192 - 0) divided by 1.075. Thus, the tax reimbursement is $.440804 (5.877388 x .075).

Assuming a marketing deduction of $.26, the taxable value would be $5.635527 (6.3181 92 - .26) , and the tax reimbursement would be $.422665 divided by 1.075.
Tax Base. The appropriate tax base is the value of the gas at the wellhead, which is generally the negotiated price paid in exchange for the gas less marketing costs:

The court in *Calvert v. Union Producing Co.*[202] determined that the negotiated contract price between the purchaser and producer is the market value of the gas at the wellhead, absent proof of bad faith, fraud or collusion. This is true even if the transaction is between related entities. The Comptroller bears the burden of proving bad faith, fraud or collusion.[203]

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200 Comptroller Letter No. 8401L1076D03 (G.C. Edgar, January 30, 1984).

201 Comptroller Letter No. 8212L1097C10 (G.C. Edgar, December 1, 1982).

202 402 S.W.2d 221 (Tex. App – Austin 1966).

203 *See also* Exxon Corp. v. Middleton, 613 S.W.2d 240 (Tex. 1981).

Back to Table of Contents

The court in *Dorchester Master Ltd P'ship v. Bullock*[204] determined that marketing costs are deductible from the producer's gross receipts in order to determine the taxable market value of tax.

D. Drip Gas, Compressor and Deydrator Liquids.

Drip gas, compressor and dehydrator liquids are taxable if the produce of the gas from which the liquids were separated receives value (consideration) for the liquids or if the liquids are returned to the producer. If the liquids are recovered by a purchaser and the producer does not receive any value for the liquids they are not taxable.

Drip gas consists of water and heavy hydrocarbons that condense from the gas stream and accumulate in the lower points of the flowlines.

Dehydrator liquids consist of water and water vapors removed from gas. Gas dehydrators are designed to handle only water and gas vapors. If liquid water or oil enters the dehydrator, the device cannot work properly.

Compressor liquids form when the pressure of air or natural gas raises to higher pressures so that the gas can flow into pipelines and other facilities.

Example. Gas Production Company (GPC) is a producer that operates a gas lease. Gas from the lease runs through a dehydrator that GPC owns. Some liquids fall out of the gas and run into the lease condensate storage tank. These liquids are taxable and should be reported as lease condensate by both the purchaser and the producer.

Example. Gas Production, Inc. (GPI) is a producer that operates two adjoining gas leases. The gas from both leases runs through a dehydrator that GPI owns. Some liquids fall out of the gas at the dehydration facility and are stored in a stock tank at the plant site, where they are occasionally sold to an area purchaser. These liquids are taxable and should be reported as lease condensate by both the purchaser and the producer.

Example. Gas Treatment Co. (GTC) owns a gas gathering and treating facility. GTC contracts with several area gas producers to perform gas gathering and treating services but doesn't purchase the gas. GTC recovers and sells compressor and/or dehydrator liquids and, under its contracts with the producers, disburses the revenue to the producers. The liquids are taxable. The purchaser should withhold and remit gas production tax to the Comptroller on the amount paid for the liquids.

Example. Gas Conditioning Company (GCC) has a gas conditioning facility on its gas transmission line. The gas conditioning facility recovers some gas liquids and sells them as condensate. GCC has purchased all of the gas flowing through the treatment plant. None of the revenue from the liquids is disbursed to the gas producers. In this case, since the gas producers don't receive fees for the liquids, they are not taxable.

[204] 794 S.W.2d 554 (Tex. App – Austin 1990).

Back to Table of Contents

Chapter V. Texas Franchise (Margin) Tax

A. Introduction

The Texas Margin Tax is a revised version of the Texas franchise tax, which has been around for many years. Beginning in 2008, the state imposes the franchise tax on virtually all forms of limited liability entities and combined groups with members doing business in Texas. The tax is imposed on margin. Margin is measured by revenues, less either cost of goods sold ("COGS"), compensation or a standard 30% deduction. The tax is apportioned to Texas based upon gross receipts. The margin tax rate is ½% for retailers and wholesalers and 1% for all other taxpayers, with exceptions for certain qualifying small businesses. These materials will interchangeably refer to the "franchise tax" and the "margin tax." Both terms reference the tax imposed under Chapter 171 of the Texas Tax Code.

A Tax on Privilege.

The Texas franchise tax is a tax on privilege. The state imposes the tax on entities in exchange for the privilege doing business in the state.[205] The privilege tax applies to entities that have enough contact with Texas in order for them to be considered to conduct business here.

[205] *See, e.g.* Rylander v. Fisher Controls Intern., Inc., 45 S.W.3d 291 (Tex. App. – Austin 2001); Home Interiors & Gifts, Inc. v. Strayhorn, 175 S.W.3d 856 (Tex. App. – Austin 2005).

Doing Business.

Texas imposes the tax on entities that are doing business in the state. Historically, this has included individual corporations and limited liability companies that conducted at least some portion of their operations in Texas. Under the revised margin calculation, the tax extends to a long list of entities, including combined groups. This has expanded the concept of "doing business" from a single-entity test to a combined group basis.

Texas statutory law defines "doing business" as broadly as it can without overstepping constitutional boundaries. The statute states: "The tax imposed under this chapter extends to the limits of the United States Constitution and the federal law adopted under the United States Constitution."[206] The franchise tax statute and the Comptroller's interpretation of the statute are subject to challenge if they conflict with the U.S. Constitution, federal statutes developed under the constitution or U.S. Supreme Court case law interpreting the Constitution. Moreover, several Texas constitutional provisions restrict the Comptroller's and Legislature's power with regard to the ability to impose tax on persons and businesses.

The following types of activities constitute "doing business in Texas" under the Texas margin tax:[207]

[206] Texas Tax Code § 171.001.
[207] *See* Comptroller Rule 3.546.

Contracting:

- performing a contract in Texas, regardless of whether the taxable entity brings its own employees into the state, hires local labor, or subcontracts with another

Providing Services:

- providing any service in Texas, regardless of whether the employees, independent contractors, agents, or other representatives performing the services reside in Texas;
- maintaining or repairing property located in Texas whether under warranty or by separate contract; or
- installing, erecting, or modifying property in Texas;

Owning Inventory:

- having an inventory in Texas or having spot inventory for the convenient delivery to customers, even if the bulk of orders are filled from out of state;

Soliciting:

- having employees, independent contractors, agents, or other representatives in Texas, regardless of whether they reside in Texas, to promote or induce sales of the foreign entity's goods or services;

Maintaining a Place of Business:

- maintaining a store or other place of business in Texas;
- doing business in any area within Texas, even if the area is leased by, owned by, ceded to, or under the control of the federal government;

Real Estate Dealings:

- holding, acquiring, leasing, or disposing of any real property located in Texas;
- owning a royalty interest in an oil and gas well located in Texas;[208]

Performances:

- the staging of shows, theatrical performances, or other events within Texas;

Transportation:

- carrying passengers or freight (any personal property including oil and gas transmitted by pipeline) from one point in Texas to another point within the state, if pickup and delivery, regardless of origination or ultimate destination, occurs within Texas; or
- having facilities and/or employees, independent contractors, agents, or other representatives in Texas, regardless of whether they reside in Texas:
  - for storage, delivery, or shipment of goods;
  - for servicing, maintaining, or repair of vehicles, trailers, containers, and other equipment;
  - for coordinating and directing the transportation of passengers or freight; or
  - for doing any other business of the taxable entity;

Franchising:

- entering into one or more contracts with persons, corporations, or other business entities located in Texas, by which the franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system prescribed in

[208] Comptroller's Franchise Tax FAQs, available online at http://cpa.state.tx.us/taxinfo/franchise/faq.html.

substantial part by the franchisor; and

- the operation of a franchisee's business pursuant to such plan is substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate;

Manufacturing & Processing:

- assembling, processing, manufacturing, or storing goods in Texas;

Advertising:

- entering Texas to purchase, place, or display advertising when the advertising is for the benefit of another and in the ordinary course of business (e.g., the foreign corporation makes signs and brings them into Texas, sets them up, and maintains them);

Processing & Shipment Contracting:

- sending materials to a Texas manufacturer, processor, repairer, or printer to be processed and stored in completed form awaiting orders for their shipment;

Loan Production:

- soliciting sales contracts or loans, gathering financial data, making credit checks, or performing other financial activities in Texas through employees, independent contractors, or agents, regardless of whether they reside in Texas;

Holding Companies:

- maintaining a place of business in Texas or managing, directing, and/or performing services in Texas for subsidiaries or investee entities;

Consigning Goods:

- having consigned goods in Texas;

Delivering Goods:

- delivering into Texas items a business has sold; and

Leasing:

- leasing tangible personal property which is used in Texas.

B. Tax Imposed

Texas imposes the franchise (margin) tax on each taxable entity that does business in this state or that is chartered or organized in this state.[209]

Under the margin tax, the following types of entities are subject to tax:

<u>Corporations</u>

Texas has always imposed franchise tax on corporations. This includes regular "C" corporations and close corporations. It also includes corporations that have elected to be treated as pass-through S corporations under federal law.

Limited Liability Companies. Limited liability companies (LLCs) have historically been subject to franchise tax and remain taxable entities under the new margin computation.

LLCs are neither corporations nor partnerships but are like a hybrid of the

[209] Texas Tax Code § 171.001.

two types of entities.[210] For state tax purposes, LLCs enjoy much of the liability protection that corporations do. For federal tax purposes, LLCs are generally treated as partnerships or disregarded entities, unless the owner or owners elect under the "check-the-box" regulations to be treated as a corporation. This combination of traits allows them to be treated as pass-through entities for federal tax purposes and still enjoy limited liability protection under state law.

Series LLCs. The Comptroller's office treats a series LLC as a single legal entity. It pays one filing fee and registers as one entity with the Texas Secretary of State. It files one franchise tax report as a single entity, not as a combined group, under its main Texas taxpayer identification number. If one of the series has nexus in Texas, the Comptroller considers the entire series LLC to have nexus in Texas.[211]

Banking Entities

Banking Corporations. "Banking corporation" means each state, national, domestic, or foreign bank, whether organized under the laws of this state, another state, another country, or under federal law.

The margin tax statute defines a "banking corporation" as "each state, national, domestic, or foreign bank" except for bank holding companies.[212] This definition includes …

- State banks
- National banks
- Domestic banks
- Foreign banks
- Limited banking associations organized under Subtitle A, Title 3, Finance Code
- Banks organized under Section 25(a), Federal Reserve Act (12 U.S.C. Sections 611-631) (edge corporations)

Bank Holding Companies. A "bank holding company" is generally any company which has control over any bank.[213] Bank holding companies are taxable entities subject to the Texas margin tax as holding companies.[214] However, they are not treated as "banking corporations" for apportionment purposes.

Savings and Loan Associations. These include a savings and loan association or savings bank, organized under Texas law, law of another state or country, or federal law.[215]

Partnerships

Partnerships doing business in Texas may be subject to the margin tax regardless of whether they're formed in Texas, in some other state or internationally.

In Texas, partnerships are governed by Title 4 of the Texas Business Organizations Code. Texas Code defines a partnership as "an association of two or more persons to carry on a

210 BNA Portfolio 725-2nd. Limited Liability Companies. I. Introduction: Choice of Entity Considerations.
211 Comptroller FAQs (Updated 09/09/11).
212 Texas Tax Code § 171.0001(3).
213 Section 2, Bank Holding Company Act of 1956 (12 U.S.C. § 1841).
214 Texas Tax Code § 171.0002.
215 Texas Tax Code § 171.0002.

business for profit as owners.[216] A partnership is formed as a matter of law regardless of whether the persons engaging in the business *intend* to create a partnership.[217] A business meeting the definition will be treated as a partnership under Texas law regardless of whether it's called a "partnership," a "joint venture," or some other name.[218]

Unless they qualify for specific exemption, various types of partnerships are subject to the franchise tax, including, general partnerships, limited partnerships, and limited liability partnerships. A limited liability partnership is a type of general partnership that registers for limited liability status by filing an application with the Texas Secretary of State.[219]

Trusts

Business Trusts. A trust is characterized by having a trust corpus (the trust assets) a trustee (who manages the assets) and at least one beneficiary (who may obtain future benefit from the trust assets). A business trust is a trust formed for the purpose of making a profit.

Business trusts generally engage in some sort of commercial activity. They are generally governed by officers who have management duties. The owners of a business trust generally hold transferable certificates of interest. A business trust is a separate legal entity that survives the death of its beneficiaries. Business trusts benefit from limited liability and offer legal protection to their beneficiaries. Therefore, they're subject to the margin tax.

Associations

Professional Associations. A "professional association" is formed as an association, as distinguished from a partnership, a corporation or a trust. Titles 6 and 7 of the Texas Business Organizations Act govern associations.[220] The term "association" includes a cooperative association, a nonprofit association, and professional association.[221]

Business Associations. Business associations are also taxable. The Texas Business Organizations Code defines a "business" broadly as any trade, occupation, profession, or other commercial activity.[222]

Other Entities

Joint Venture. The term "joint venture" generally refers to a temporary partnership "organized to carry out a particular business enterprise for profit."[223] While joint ventures are generally partnerships, they may take other forms.[224] In Texas, a joint venture may be formed as a partnership, under operation of law, where the parties to the

216 *See* Texas Business Organizations Code § 152.051 *et seq.*
217 *Id.*
218 *Id.*
219 Texas Business Organizations Code § 152.802.

220 Texas Business Organizations Code § 301.003(2).
221 Texas Business Organizations Code § 1.002(3).
222 Texas Business Organizations Code § 1.002(5).
223 BNA Portfolios, 700-2nd Choice of Entity, II, C.
224 *Id.*

venture agree to share in management and divide profits.

Joint Stock Companies. A joint stock company generally combines partnership features with those of corporations. They are generally able to access the stock markets' liquidity and financial reserves as a corporation would. However, stockholders are often liable for the joint stock company's debts and endure other restrictions, similar to partners in a partnership.

Holding Companies. A holding company is an entity formed for the sole purpose of owning and controlling other companies. Holding companies are subject to the margin tax.

Combined Entities. The statute defines a combined entity as a single taxable entity. This is significant because it affects the calculation of the margin tax.

Other Legal Entities. The list of taxable entities ends with "any other legal entity." Therefore, if a particular entity isn't listed as exempt from the tax, the law presumes it is a taxable entity.

C. Nontaxable Entities

The Tax Code specifically excludes certain entities from the margin tax.[225] This is important because the Texas Constitution prohibits the state from imposing a tax on the income of a natural person or a natural person's income from a partnership.[226] While there's still some question over whether the tax is an "income tax," the legislature determined that the business was imposed on entities and therefore did not violate the Bullock amendment of the Texas Constitution.[227] In addition, the legislature has excluded certain types of business entities from taxation. This includes, but is not limited to, the types of charitable and religious organizations historically granted exempt status under the Texas franchise tax.

Sole Proprietorships. A sole proprietorship is a business owned and controlled by one person. Sole proprietorships are not separate legal entities from their owners and do not offer any form of legal liability protection. The owner of a sole proprietorship owns all of the business's assets and is personally responsible for all of its liabilities.

Caveat: Sole proprietorships may be taxable if they receive limited liability protection (including formation in foreign countries that limits liability).[228]

Certain General Partnerships. A general partnership is not subject to margin tax if it is directly owned *solely* by natural persons.[229] This means that a general partnership with an LLC partner is presumptively a taxable entity.[230]

The exclusion for general partnerships makes sense because each partner of a general partnership bears unlimited liability for the partnership's debts.[231] Therefore, general partnerships

225 Texas Tax Code § 171.0002(b) & (c).
226 *See* Bullock Amendment.

227 *Allcat Claims Service, L.P. v. Combs,* Tex. Sup. Ct. Case No. 11-0589.
228 *See* HB 3928.
229 Texas Tax Code § 171.0002(b)(2).
230 *Cf.* Passive Entity Rules (see below).
231 *See* Prentice Hall p. 2-4. A general partner's liability is not limited to the balance of the partner's capital account.

aren't receiving the limited liability afforded to taxable entities.

The revised margin tax statute specifies that general partnerships are taxable if they have limited liability. In order to be excluded from the definition of "taxable entity" the liability of the general partnership must not be "limited under a statute of this state or another state, including by registration as a limited liability partnership."[232]

If an IRA is a partner in a general partnership, then the partnership is a taxable entity.[233]

Grantor Trusts. A grantor trust is defined by reference to the Internal Revenue Code, Sections 671 and 7701(a)(30)(E). A grantor trust exists when the person who places property into a trust retains control or dominion over the property. For federal tax purposes, grantor trusts are treated as disregarded entities and any trust income is taxable to the grantor.

In order for a grantor trust to qualify as a nontaxable entity for Texas franchise tax purposes, all grantors and trust beneficiaries must be either natural persons or charitable entities. The Tax Code refers to IRC § 501(c)(3) to determine what entities qualify as charitable.

Grantor trusts that are taxable as business entities for federal tax purposes are treated as taxable business trusts for Texas franchise tax purposes.[234] These arrangements are known as trusts because the legal title to property is conveyed to trustees for the benefit of beneficiaries. However, they are not classified as trusts for Internal Revenue Code purposes because they are not simply arrangements to protect or conserve the property for the beneficiaries.[235]

Estates. When an individual dies, his or her assets and liabilities form a legal entity called an estate. A natural person's estate is not subject to Texas margin tax.[236] This makes sense, given the Texas constitutional prohibition against taxing the net income of natural persons. However, this provision does not apply to bankruptcy estates.

Escrows. An escrow is a fund or deposit held by a third party (an escrow agent) to be turned over to a grantee upon the fulfillment of a condition.[237] Temporary escrows are frequently used in real estate and business transactions to hold deposits in compliance with the contract between the parties. Although often associated with business, escrows themselves are not business entities and are therefore not subject to margin tax.

Real Estate Investment Trusts. A real estate investment trust (REIT) is an entity formed to hold indirect interests in real estate. The indirect interests generally take the form of partnership shares.[238]

232 HB 3928, amending § 171.0002(b)(2).
233 *See* Comptroller FAQs (Updated 07/21/10).
234 *See* Texas Tax Code § 171.0002(c).
235 *See* Treasury Regulation § 301.7701-4(b).
236 Defined by reference to Internal Revenue Code ("IRC") § 7701(a)(30)(D). This excludes an estate taxable as a business entity pursuant to Treasury Regulation § 301.7701-4(b).
237 *See* Merriam-Webster's Dictionary of Law ©1996, available online at www.findlaw.com.
238 For more information see BNA Portfolio 742-2d Real Estate Investment Trusts.

Back to Table of Contents

In order to qualify as a REIT for federal tax purposes, an entity must meet certain requirements.[239] The REIT may not hold direct holdings of real estate, except for real estate that the REIT occupies for its own business purposes. Since both the investors and the taxable entities will be paying federal tax, the REIT is entitled to exclude dividend payments, in order to prevent triple taxation. For the same purposes, REITS are not subject to margin tax, because their revenues will be taxed either at the partnership level, or the investor level, or potentially both.[240]

Qualified REIT Subsidiaries. A REIT is prohibited from providing services for the tenants in the real estate it operates. However, a REIT may form a "qualified REIT subsidiary" in order to perform these functions, as long as it meets certain requirements.[241] A qualified REIT subsidiary is then entitled to the same dividend exclusions as its parent.

Real Estate Mortgage Investment Conduits. A real estate mortgage investment conduit (REMIC) is also a nontaxable entity for margin tax purposes. Like REITs, REMICs are defined under federal law and must meet Internal Revenue Code requirements before being nontaxable in Texas.[242] In general, a REMIC is an entity that allows investors to engage in indirect mortgage investments with varying levels of risk. REMICs generally hold real estate mortgage investments, such as federal bonds and qualified mortgages.

For the same reasons as REITs and Qualified REIT subsidiaries, REMICs may exclude dividends paid from federal taxable income. Therefore, they're also exempt from paying Texas margin tax.

Certain Joint Ventures. Joint ventures that elect out of federal partnership status are not subject to margin tax.[243] Joint ventures are eligible to elect out of federal partnership status if the participants are involved in the joint production, extraction or use of property and meet the following requirements:[244]

- They jointly own the property as co-owners under an agreement, lease or other contract that grants exclusive operating rights;
- They each retain separate rights to take in-kind or dispose of their shares of any property produced, extracted, or used; and
- They refrain from jointly selling services or the property produced or extracted.[245]

In addition to meeting these requirements, the joint venture must elect out of federal partnership status in order to be exempt for margin tax purposes.[246] These types of joint ventures are common in the oil and gas industry.

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239 For more information see BNA Portfolio 742-2d Real Estate Investment Trusts.
240 A limited partnership or other entity that directly holds the real estate is not exempt without regard to whether a REIT holds an interest in it.
241 IRC, § 856(i)(2).
242 IRC, § 860D.
243 Tax Code § 171.0002(a).
244 *See* Treasury Regulation § 1.761-2(a)(3).
245 However, each separate participant may delegate authority to sell his share of the property for the time being for his account, but not for a period of time in excess of the minimum needs of the industry, and in no event for more than 1 year.
246 IRC § 761(a).

Back to Table of Contents

D. Exempt Entities

Exempt entities must qualify for exemption from the franchise tax. A non-profit organization or other entity must submit an exemption application to the Exempt Organization Section of the Comptroller's office along with supporting documentation.[247] The requirements are set forth in Comptroller Rule 3.583. Detailed instructions are available online at:

http://www.cpa.state.tx.us/taxinfo/taxpubs/tx96_1045.html.

Non-profit entities that have been granted an exemption from the Comptroller's office are not required to file franchise tax reports, including the Public Information Report or Ownership Information Report. If the entity has not requested or been granted an exemption, the entity must file all reports. The exemption does not take effect until it is approved.[248]

Historically Exempt Entities. Charities, religious organizations and other traditionally exempt entities remain exempt from the franchise tax under the new margin computation. These entities remain exempt, regardless of the type of entity engaging in the exempt operations:[249]

[247] Comptroller's FAQs Exemptions, Question 1. Available online at: http://www.cpa.state.tx.us/taxinfo/franchise/faq_exempt.html#exempt1. (updated 4/23/08)
[248] Comptroller's FAQs Exemptions, Question 2.
[249] *See* Texas Tax Code § 171.051 to .086 (Vernon 1992); Comptroller Rule 3.573 also sets out the procedure for obtaining a temporary franchise tax exemption while a corporation awaits its exemption from the Internal Revenue Service.

- non-profit entities organized for religious worship;[250]
- educational purposes, including student loans and scholarships;[251]
- public charities;[252]
- entities exempt from federal income tax under IRC §§ 501(c) (2), (3), (4), (5), (6), (7), (16) or (25);[253]
- agricultural nonprofits;[254]
- farm mutual insurance companies, local mutual aid associations, and burial associations;[255]
- railway terminal associations with no annual net business income;[256]
- open-ended investment companies registered under the Securities Act;[257]
- entities engaged solely in the business of manufacturing, selling or installing solar energy devices;[258]
- entities engaged for purposes of conservation,[259] recycling operations, water supply or sewer services;[260]
- certain homeowners' associations and nonprofit housing cooperatives,[261]
- farmers' co-ops and agricultural marketing associations;[262]
- credit unions and credit co-ops; [263]

[250] Texas Tax Code Ann. § 171.058 (Vernon 1992).
[251] Texas Tax Code Ann. § 171.061 (Vernon 1992).
[252] Texas Tax Code Ann. § 171.062 (Vernon 1992).
[253] Texas Tax Code Ann. § 171.063 (Vernon 1992).
[254] Texas Tax Code § 171.060.
[255] Texas Tax Code § 171.0525.
[256] Texas Tax Code § 171.053.
[257] Texas Tax Code § 171.055. (requiring registration under 15 USC § 80a-1 *et seq.*
[258] Texas Tax Code § 171.056.
[259] Texas Tax Code § 171.064.
[260] Texas Tax Code § 171.065.
[261] Texas Tax Code § 171.068 and § 171.082.
[262] Texas Tax Code § 171.069 and § 171.071.
[263] Texas Tax Code § 171.076 and § 171.077.

- electrical and telephone co-ops;[264]
- other listed entities formed for exempt or public purposes.

2010 Update. The Comptroller revised the list of exempt entities in Rule 3.583 to remove IRC § 501(c)(9) entities from the list of entities that are exempt if they receive a Comptroller letter. IRC § 501(c)(9) entities are voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or designated beneficiaries, if no part of the net earnings of such association inures (other than through such payments) to the benefit of any private shareholder or individual.

Unlike federal tax reporting requirements, if an entity has been approved as exempt and continues to maintain the qualifications for the exemption, it is not required to file Texas franchise tax reports for unrelated business income.[265]

Charitable Bingo. The 2009 legislature exempted from Texas franchise tax charitable bingo organizations formed under the Occupations Code.

Unincorporated Political Committees. The 2011 legislation adds a franchise tax exemption for unincorporated political committees. The exemption applies to "an unincorporated entity organized as a political committee under the Election Code or the provisions of the Federal Election Campaign Act of 1971 (2 U.S.C. Section 431 et seq.)."[266]

Insurance Companies Paying Gross Premiums Tax. Insurance companies authorized to engage in the insurance business in Texas are generally exempt from margin tax. Instead, insurance companies and title insurance agents must pay the annual insurance gross premiums tax.

Even non-admitted insurance organizations may be exempt from margin tax. The non-admitted insurance organizations will be exempt from margin tax only for years in which they are required to pay gross premium receipts tax.

Insurance companies are subject to the margin tax if, for any portion of a year, they are in violation of an order issued by the Texas Department of Insurance regarding unfair discriminatory premium rates. The order must be final after appeal or no longer subject to appeal.

Employee Benefit and Self-Insurance Trusts. The revised margin tax statute also excludes the following types of entities from the margin tax:

- Non-profit self-insurance trusts for health-care liability claims;[267]
- Trusts created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries;[268] and

264 Texas Tax Code § 171.079 and § 171.080.
265 Comptroller's FAQs Exemptions, Question 3.
266 SB 1, Article 45.
267 Created under Texas Insurance Code, Chapter 2212.
268 Qualified IRC § 401(a) trusts.

Back to Table of Contents

- Voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such associations or their dependents or designated beneficiaries, if no part of the net earnings of such association inures (other than through such payments) to the benefit of any private shareholder or individual.[269]

E. Passive Entities

Passive entities must meet three requirements in order to be considered nontaxable:[270]

First, they must be organized as a qualifying type of entity. Only the following types of entities will qualify as passive:

- general partnerships[271]
- limited partnerships[272]
- limited liability partnerships[273]
- non-business trusts[274]

Under this definition, corporations and limited liability companies that were previously taxable under the franchise tax don't qualify as passive entities.

Tip: An entity that fails as a nontaxable general partnership may qualify as a passive entity if it derives its revenues from passive sources.

[269] IRC § 501(c)(9) trusts.
[270] Texas Tax Code § 171.0003.
[271] Texas Tax Code § 171.0003(a)(1).
[272] Texas Tax Code § 171.0003(a)(1).
[273] Comptroller Rule 3.582(c)(1).
[274] Texas Tax Code § 171.0003(a)(1).

Caution: The Comptroller has stated that an entity must be a qualifying entity for the entire accounting period on which the tax is based in order to qualify as passive.

Second, passive entities must earn 90% of their gross federal income from passive sources during the period on which margin is based. These "passive sources" vary in many ways from those used for federal income tax purposes. For the margin tax, the following types of revenues are passive:

Investment revenues:
- dividends
- interests

Gains:
- on exchange of foreign currency
- *capital gains* from sales of real property
- from sales of commodities traded on a commodities exchange
- from the sale of securities

In computing gains, the Comptroller has directed taxpayers to evaluate the *net* gains and *net* capital gains, as reported on the federal tax return, in determining the percentage of revenues that represent passive revenues.

In determining the nature of net gains from sales of securities, the Comptroller allows only gains from the sale of a non-controlling interest as passive. The Comptroller's rules state that the determination of what constitutes a "non-controlling interest" is fact specific and will be determined on a case-by-case basis.[275]

[275] Comptroller Rule 3.582(b)(9).

Back to Table of Contents

Certain pass-through revenues:

- income received from LLC s
- distributive shares of partnership income[276]

The following payments with respect to financial instruments:

- notional principal contract payments
- option premiums
- cash settlements
- termination payments

Certain oil and gas revenues:

- royalties, bonuses, or delay rental income from mineral properties
- income from other nonoperating mineral interests

Oil and gas revenues are only considered passive if the recipient is not affiliated with the operator. An entity is considered affiliated with the operator if the operator and the entity share *more than 50%* direct or indirect ownership or control.

Third, passive entities must earn less than 10% of their federal gross income from conducting an active trade or business. The statute specifies that passive revenue sources (defined above) are *not* treated as active revenues for the purposes of this test.

Active revenue, in general, is revenue from activities the entity engages in for the purpose of earning income or profits. If the revenue sources include one or more active operations and the entity performs active management and operational functions, the gross income from those sources will be included in active revenues.

[276] To the extent that those distributive shares of income are greater than zero (no offsetting).

An entity's activities include activities performed by agents outside the entity, including independent contractors. Revenues from these activities are included in active revenues to the extent the agents perform services on the entity's behalf and those services constitute all or part of the entity's trade or business.

The following revenues are considered active:

- rent
- income a non-operator receives from mineral properties under a joint operating agreement (the non-operator must not be a member of the same affiliated group as the operator under the joint operating agreement)

Caution. Passive entities aren't subject to the margin tax or the exit tax for the periods they qualify as passive. **However, a taxable entity owning a passive entity interest** must include and pay margin tax on its share of the passive entity's income.[277]

Exception. "A taxable entity that owns an interest in a passive entity shall exclude from the taxable entity's total revenue the taxable entity's share of the net income of the passive entity, but only to the extent the net income of the passive entity was generated by the margin of any other taxable entity."[278]

An entity conducts an active trade or business if assets, including royalties, patents, trademarks, and other intangible assets, held by the entity are used in the

[277] Texas Tax Code § 171.1011(e).
[278] Texas Tax Code § 171.1011 (e).

active trade or business of one or more related entities.

The following revenues are excluded from the definition of "active":

- owning a royalty interest or a non-operating working interest in mineral rights
- paying compensation to employees or independent contractors for financial or legal services reasonably necessary for the entity's operations

Merely holding a seat on the board of directors of an entity doesn't constitute the conduct of an active trade or business.

Passive Entity Reporting.

A passive entity is not required to pay the franchise tax but must file a No Tax Due Information Report and check a box indicating that the entity qualifies as passive.

2011 Update. Effective for reports originally due on or after Jan. 1, 2011, a passive entity that is registered (or required to be registered) with either the Secretary of State or the Comptroller's office must file Form 05-163 to affirm the entity qualifies as passive for the period upon which the tax is based. Under the revised rules, a passive entity that has not notified the Comptroller or the Secretary of State that it is doing business in Texas is still not required to register with or file a franchise tax report with the Comptroller's office.

However, any passive entity that no longer qualifies as passive must file a franchise tax report for the period in which the entity does not qualify as passive, and any subsequent periods, until the entity once again files as a passive entity. In addition, an entity that receives notification from the Comptroller asking if the entity is taxable must reply to the Comptroller within 30 days of the notice and provide proof of its status.

F. Forfeiture Provisions

Historically, the Comptroller has had the power to revoke the corporate privileges of corporations and LLCs that fail to comply with their franchise tax reporting or payment obligations.

The revocation of corporate privileges can lead to unlimited liability for corporate officers and directors during the forfeiture period, which extends from the date of noncompliance to the date the corporation files all of its past-due reports and pays all of the past-due liabilities.

Even after the entity has fulfilled its obligations, the officers and directors remain exposed for debts and obligations created or incurred during the forfeiture period. This includes not only the corporation's franchise tax debts, but also its sales and use tax obligations, tort claims and other liabilities.

The revisions to the margin tax clarify that the Comptroller has similar powers with respect to other types of entities as well.

For businesses operating in the oil and gas industry franchise tax forfeiture can mean not only personal liability for taxes, but also personal liability for oilfield cleanup fees that go unpaid by the business entity after an oil spill.[279]

G. Special Rules for Small Entities

Exemption. A taxable entity won't owe Texas franchise tax if its total revenue from its entire business for the margin tax measurement period is less than or equal to $300,000 (for 2008 and 2009), and $1 million (for 2010 through 2013).[280] The amount is indexed biennially for inflation with reference to the consumer price index.[281] A taxpayer filing a short period return must evaluate its revenue pro-rata for the portion of the year its report covers. The amount of minimum total revenue is scheduled to drop to $600,000 (for 2014 onward).[282] A taxable entity also won't owe tax if the amount of margin tax computed for the year is less than $1,000.[283]

Reporting. The Comptroller still requires taxable entities qualifying for the exemption to file a short "no tax due" report and the public information report.

Credits. For 2010 through 2013, since the minimum threshold for margin tax liability is increased to $1 million, small business credits are no longer relevant. However, beginning in 2014, the credits from $600,000 through $900,000 will go back into effect.

$600,000 - <$700,000	40% credit
$700,000 - <$900,000	20% credit
$900,000 and Over	no credit

The E-Z computation continues to be an option for taxable entities or combined groups with less than $10 million in total revenues. Taxable entities with less than $10 million in total revenues may elect the E-Z computation in lieu of the margin calculation. The E-Z computation is 0.575% of apportioned total revenues. No credits will be allowed under the E-Z computation, except for the small business credits for entities with less than $900,000 in total revenues (for 2014 onward).

Annualizing. The Comptroller has taken the position that the amounts for the minimum taxability threshold, the E-Z computation and the discounts must be annualized in order to determine eligibility. This means that an entity in business for only part of the period on which margin is based must calculate their revenues on an annual basis before applying the discount or electing the E-Z computation.

Example. An entity in business for nine months of 2012 could file a "no tax due" information report for 2013 if its revenues were less than $750,000 ($1,000,000 x 9/12).

H. Electing a Deduction

Eligible entities may elect to deduct compensation, COGS, or a "standard" 30% deduction from revenues. They may make the election which results in the lowest margin. The entity must make the election by the deadline for filing the margin tax report. If an entity

279 *See, e.g.*, Martin v. State, 2007 WL 2214502 (Tex. App. – Austin) (holding an officer of a defunct Texas corporation individually responsible for clan up fees due after the corporation failed to pay its franchise taxes and forfeited its corporate privileges and charter.

280 The exemption limit had been scheduled to go down to $600,000 in 2012 and subsequent periods.

281 Texas Tax Code § 171.006(a).

282 Texas Tax Code § 171.002(d)(2).

283 Texas Tax Code § 171.002(d)(1).

fails to make a timely election, or fails to timely file a valid extension request, the Comptroller will limit the entity to the 30% deduction.[284] The deduction election is made on an annual basis, and may change from year to year.

The Comptroller has reconsidered its position with regard to the election to take the COGS or compensation deduction when filing an amended long form franchise tax report.

The Comptroller originally disallowed the filing of an amended report after the due date of the report to change the method of computing margin to a COGS deduction or to a compensation deduction.[285]

The Comptroller has revised her policy to allow taxpayers to amend reports to change their elections, or to make an election, to use the COGS or the compensation deduction. Taxpayers that elected to use the E-Z computation report or filed the "no tax due" information report may also amend to the long form and make an election to use the COGS or the compensation deduction. Taxpayers may file amended reports for any periods within the statute of limitations.

This change in policy with regard to amending reports does not change the eligibility requirements that must be met in order to deduct COGS or compensation.

[284] Comptroller Rule 3.584 (d)(1).
[285] Comptroller Rule 3.584.

I. Tax Rate

Texas imposes margin tax on retailers and wholesalers at the rate of 0.5%. All other taxable entities pay the 1% rate. The half-percent rate applies if the entity is primarily engaged in retail or wholesale trade.

The statute defines retail and wholesale trade by referring to the federal Office of Management and Budget's Standard Industrial Classification Manual. If the business activity has an SIC code numbered in the 5000s (Division F or Division G), it's a wholesaling or retailing activity.[286]

Apparel Rental Companies
Effective January 1, 2012 apparel rental companies, such as tuxedo rental businesses, may qualify as retailers or wholesales in order to obtain a reduced 0.5% tax rate.[287] In order to qualify for the reduced rate the apparel rental companies' activities must be classified as Industry 5999 or 7299 of the 1987 Standard Industrial Classification Manual published by the federal Office of Management and Budget.[288] In addition, the apparel rental company must meet the other requirements for the reduced retail/wholesale rate:

[286] The U.S. Department of Labor offers a Standard Industrial Classification (SIC) search online at http://www.osha.gov/pls/imis/sicsearch.html
[287] 2011 Legislative Session, SB 1, Article 51.01.
[288] The statute defines retail and wholesale trade by referring to the federal Office of Management and Budget's Standard Industrial Classification Manual. If the business activity has an SIC code numbered in the 5000's (Division F or Division G), it's a wholesaling or retailing activity. The U.S. Department of Labor offers a Standard Industrial Classification (SIC) search online at http://www.osha.gov/pls/imis/sicsearch.html.

- A taxable entity's total revenues from retail and wholesale activities must exceed the total revenues from its other activities.[289] Generally, if the business activity has an SIC code numbered in the 5000s (Division F or Division G), it's a wholesaling or retailing activity. This bill expands that definition to include Industry 7299.

- Less than half of the taxable entity's revenue from activities in retail or wholesale trade must come from the sale of products produced by the taxable entity or by an entity that is part of the same affiliated group.[290] This means a retailer or wholesaler must sell more goods produced by others than it does of its own goods or those produced by its affiliates. The manufacturer exclusion doesn't apply to restaurants and bars (specifically, activities classified in Major Group 58 of the SIC Manual "Eating and Drinking Places").[291]

The taxable entity cannot sell retail or wholesale utilities and qualify for the half-percent rate. This includes telecommunications, electricity, and gas.[292]

Predominately Retail / Wholesale

A taxable entity's total revenues from retail and wholesale activities must exceed the total revenues from its other activities.[293] Therefore, a retailer or wholesaler may provide services or engage in other non-retail or wholesale businesses, as long as the other activities don't generate more revenues than selling goods.

Manufacturer Exclusion

Less than half of the taxable entity's revenue from activities in retail or wholesale trade must come from the sale of products produced by the taxable entity or by an entity that is part of the same affiliated group.[294] This means a retailer or wholesaler must sell more goods produced by others than it does of its own goods or those produced by its affiliates. The manufacturer exclusion doesn't apply to restaurants and bars (specifically, activities classified in Major Group 58 of the SIC Manual "Eating and Drinking Places").[295]

Under revised Rule 3.584 the Comptroller won't consider a product to be "produced" if modifications made to the acquired product do not increase the sales price of the product by more than 10%. The following examples are from the January 2010 issue of Tax Policy News.

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289 Texas Tax Code § 171.002(c)(1).
290 Texas Tax Code § 171.002(c)(2).
291 Texas Tax Code § 171.002(c-1). The Comptroller amended Rule 3.584 in 2010 to state that the Comptroller won't consider a product to be "produced" if modifications made to the acquired product do not increase the sales price of the product by more than 10%. This determination of whether a product is "produced" is relevant for determining if the retail tax rate applies. The reduced rate of 0.5% applies only if a taxable entity derives its predominate revenues from retail or wholesale trade of goods not manufactured by the entity or its affiliates.
292 Texas Tax Code § 171.002(c)(3).
293 Texas Tax Code § 171.002(c)(1).
294 Texas Tax Code § 171.002(c)(2).
295 Texas Tax Code § 171.002(c-1).

Back to Table of Contents

Example. A taxable entity is a retailer in the business of selling baseball caps that are embroidered at the shop to a customer's specifications. The entity purchases the baseball caps from a manufacturer and sells them, without embroidery, for $10 each. An embroidered cap sells for $18. The entity is considered to be the producer of the embroidered caps since the modifications made to them increase the sales price by 80 percent. If the sale of the embroidered caps accounts for 50 percent or more of the entity's total revenue, the entity would not be eligible for the 0.5 percent tax rate because 50 percent or more of the entity's total revenue comes from the sale of products it produces.

Example. A taxable entity is a retailer in the business of selling men's dress shirts. The dress shirts sell for $60 each. A customer may purchase a dress shirt that is personalized with a monogram for $65. Monogramming the shirt is not considered production because the modifications made to the shirt increase its sales price by less than 8.5 percent. This retailer will not lose its eligibility for the 0.5 percent tax rate because of its shirt monogramming activities.

Regardless of whether an entity is eligible for the 0.5 percent tax rate, a seller of goods can still deduct the COGS to determine margin.

A foreign manufacturing affiliate, even though it is not includible in a combined group with the retailer, may prevent the retailer from being eligible for the reduced rate. The Comptroller's March 2010 Tax Policy News provides the example of an affiliated group consisting of one or more entities domiciled in the United States and a foreign entity.[296]

Example. A foreign entity is a manufacturer that conducts business outside of the U.S. (80 percent or more of the taxable entity's property and payroll are assigned to locations outside the U.S.). U.S. entities are primarily engaged in wholesale or retail trade, under Texas Tax Code § 171.002(c), and 50 percent or more of items they sell are items that the foreign entity manufactures. The foreign manufacturing entity, although part of the affiliated group, is not included in the combined group because the foreign entity conducts business outside of the U.S.[297] Under these circumstances, the taxable entity would not be eligible for the 0.5 percent tax rate.[298]

Utility Exclusion

The taxable entity cannot sell retail or wholesale utilities and qualify for the half-percent rate. This includes telecommunications, electricity, and gas.[299]

Summary

296 Comptroller Rule 3.590(b)(1) defines an "affiliated group" as entities in which an interest of more than 50 percent is owned by a common owner.
297 Texas Tax Code § 171.1014(a).
298 Texas Tax Code § 171.002(c)(2), "A taxable entity is primarily engaged in retail or wholesale trade only if...less than 50 percent of the total revenue from activities in retail or wholesale trade comes from the sale of products it produces or products produced by an entity that is part of an affiliated group to which the taxable entity also belongs..." (emphasis added).
299 Texas Tax Code § 171.002(c)(3).

The following examples are from the May 2010 issue of Tax Policy News:

Example. A taxable entity sells Swiss watches and offers repair services for these watches. This entity must compare its total revenue from the sale of watches (retail - under SIC Code 5944) to its total revenue from the repair of watches (service - under SIC Code 7631). If the total revenue from its activities in retail trade (the sale of watches) is greater than the total revenue from its activities in service trade (the repair of watches), the entity has passed the first of three tests for being primarily engaged in retail or wholesale trade. If the total revenue from its activities in service trade (the repair of watches) is greater than the total revenue from its activities in retail trade (the sale of watches), then the entity is not primarily engaged in retail or wholesale trade and is not eligible for the 0.5 percent tax rate.

For the second step, an entity must determine if less than 50 percent of the total revenue from its activities in retail or wholesale trade comes from the sale of products it produces or products produced by an entity that is part of an affiliated group to which the taxable entity also belongs.[300] If 50 percent or more of its total revenue is from the sale of products it produces or from products produced by an affiliate, the entity is not primarily engaged in retail or wholesale trade.

Continuing with the above example. Assume the entity's total revenue from the sale of watches is greater than its total revenue from the repair of watches. More than 90 percent of the store's total revenue from the sale of watches comes from the sale of watches produced by its affiliate, as defined in Tax Code § 171.0001(1), a manufacturer based in Switzerland.

Because 50 percent or more of the store's total revenue from retail comes from the sale of products manufactured by an affiliate (the affiliate does not have to be a member of the combined group to disqualify the group for the 0.5 percent rate), the entity is not primarily engaged in retail trade and is not eligible for the 0.5 percent tax rate.

The third step, Tax Code § 171.002(c)(3), does not allow taxable entities that provide retail and wholesale utilities (including telecommunications services, electricity, or gas) to be considered primarily engaged in retail or wholesale trade. As a result, these entities are not eligible for the 0.5 percent tax rate.

To summarize, a taxable entity will qualify for the 0.5 percent tax rate if the entity:

1) has total revenue from activities in retail or wholesale trade that is greater than the total revenue from activities in other trades;

2) does not produce, and does not have an affiliate that produces, products that account for 50 percent or more of the entity's total revenue from retail or wholesale trade; and

[300] Texas Tax Code § 171.002(c)(2). (this does not apply to total revenue from activities described by Major Group 58: Eating and Drinking Places)

3) does not provide retail or wholesale utilities.[301]

301 Tax Policy News, May 2010.

J. Credits

The franchise tax offers a few types of credits, the details of which are beyond the scope of these materials. One credit of potential interest to the oil and gas industry allows a credit for qualifying expenses incurred in connection with clean energy projects.

Clean Energy Credit. The 2009 legislative changes allow a credit for an entity implementing a clean energy project in connection with the construction of a new facility.

Various qualifications include certification by the Railroad Commission, completion of construction, full operability, sequestration of 70% of the carbon dioxide resulting or associated with the generation of electricity by the facility, and entering into an agreement with the Electric Reliability Council of Texas.

The credit equals the lesser of 10% of qualifying capital costs or $100 million. The credit is only applicable against the franchise tax liability related to the facility. The Comptroller may not issue a credit before September 1, 2013 and the credit expires September 2, 2013.[302]

Credits for Combined Groups. Combined groups may claim unused credit carryforwards for each member entity. Limitations are determined before any credits are applied.[303]

For reports due on or after Jan. 1, 2012, the reporting entity of a combined

302 House Bill 469 (Effective Sept. 1, 2009), amending Chapter 490, Government Code.
303 Comptroller Rule 3.593(i)(5).

Back to Table of Contents

group with a temporary credit for business loss carryforward preserved for itself and/or its affiliates must submit common owner information each year by the due date of the report. This information is necessary to satisfy franchise tax filing requirements, even if the combined group is not claiming the credit on the current year's report. For 2012, the common owner information must be submitted online.

Franchise Tax Job Creation Credit Extension (effective 9/1/2011; expires 9/1/2017). This revision extends franchise tax credits for certain job creation activities to December 31, 2016.[304] The prior extension had been through December 31, 2012. A corporation with unused credits may claim them on or with the tax report for the period in which the credit was established.

If the corporation was allowed to carry forward unused credits, the corporation may continue to apply those credits on or with each consecutive report until the earlier of the date the credit would have expired under the terms of Tax Code Chapter 171, Subchapter P, Tax Code, had it continued in existence, or December 31, 2016, and the former law under which the corporation established the credits is continued in effect for purposes of determining the amount of the credits the corporation may claim and the manner in which the corporation may claim the credits.

[304] 2011 Legislative Changes, SB 1, Article 31.01.

K. Reporting and Payment

Every taxable entity qualified to do business in Texas, doing business in Texas, or incorporated/organized in Texas on January 1 of a particular year must file a franchise tax report with the Comptroller of Public Accounts on **May 15** of that year. The report covers the period January 1 through December 31. New entities and newly-qualified foreign entities operate under special rules.

The first franchise tax report filed by a taxable entity that becomes subject to the tax on or after October 4, 2009 will be an annual report. The first annual report will be due May 15 of the year after the calendar year the entity became subject to the tax.[305]

L. Extensions

Franchise tax extensions are computed differently depending upon whether a taxable entity is required to pay its tax by electronic funds transfer ("EFT"). Taxpayers who paid a total of $10,000 or more in a particular tax category during the preceding state fiscal year (September 1 through August 31) must pay the current year's tax by EFT. The Comptroller may assess a 5% penalty on taxpayers who fail to use EFT when required to do so.

The electronic payment requirement expanded in 2008 to include taxpayers who paid a total of $10,000 or more in a particular tax category during the preceding state fiscal year, causing many more taxpayers to be required to pay by electronic funds transfer. The electronic *reporting* requirement applies to a

[305] Tax Policy News October 2009. *See also* changes to Comptroller Rule 3.584.

taxpayer who paid $50,000 or more during the preceding fiscal year.

Non-EFT Extension. Taxpayers not required to pay franchise tax electronically may extend the deadline to file an annual report from May 15 to November 15, if the taxable entity:

(a) requests the extension on or before May 15;
(b) on a form provided by the Comptroller; and
(c) remits with the request at least 90% of the tax that will be due or 100% of the tax due the previous year.

Non-EFT Penalty and Interest. If the Comptroller later assesses tax against a taxpayer who extends the filing deadline, penalty and interest will be calculated as though the following were due dates:

(a) If the extension is granted and the taxpayer pays at least 100% of the prior year's tax or at least 90% of the current year's tax by May 14, then November 15 will be the due date for any additional tax due.

(b) If the taxpayer timely requests an extension but doesn't make a sufficient payment, then May 15 is the due date for 90% of the tax finally determined to be due and November 15 is the due date for 10% of the tax finally determined to be due.

EFT Extension to August 15. Taxable entities required to pay by electronic funds transfer may extend the filing deadline from May 15 to August 15, if the taxable entity:

(a) requests the extension on or before May 15
(b) on a form provided by the Comptroller; and
(c) remits with the request at least 90% of the tax that will be due or 100% of the tax due the previous year.

EFT Extension to November 15. Taxable entities required to pay by electronic funds transfer may further extend the deadline to November 15, if the taxable entity:

(a) requests the extension on or before August 15;
(b) on a form provided by the Comptroller; and
(c) remits with the request the difference between the amount paid previously for the current reporting period and 100% of the amount of tax reported as due on the report filed on or before November 15.

Taxpayers required to pay their franchise taxes electronically (mandatory EFT) have two potential franchise tax filing deadline extensions. The first extension is from May 15 to August 15; the second extension is until November 15. The payment with the second extension should equal the balance of the amount of tax that will be reported as due on or before November 15. If all the tax due was paid with the entity's first extension request, a taxpayer may use Web File to request the second extension without making an additional payment. Taxpayers may also mail a Texas Franchise Tax Extension Request (Form 05-164) to the address on the form. Taxpayers electronically filing for an extension are not required to file the paper form.[306]

[306] Tax Policy News, May 2010.

Back to Table of Contents

If a second extension payment is due:

- Taxpayers who paid $10,000 or more, but less than $100,000 in franchise tax during the preceding state fiscal year may make their electronic extension payment using WebFile (credit card or WebEFT). Taxpayers in this category who are enrolled in TEXNET can use TEXNET to make their extension payment.

- Taxpayers who paid $100,000 or more in franchise tax during the preceding state fiscal year must use TEXNET to make their electronic extension payment.

Combined groups using TEXNET must mail a Texas Franchise Tax Extension Affiliate List (Form 05-165) with their first extension request, but should not include the affiliate list with the second extension request. They are not required to make a separate extension request if they use TEXNET or WebFile to make an extension payment.

A taxable entity that preserved its business loss carryforward for the temporary credit must claim the credit by the due date of its report. If an entity required to pay electronically does not request the second extension, the extended due date is August 15. If the entity files a franchise tax report after the extended due date, the temporary credit for this year cannot be applied to the tax due and cannot be carried forward for use in future years because the report was not filed timely.

EFT Penalty and Interest. If the Comptroller later assesses tax against a taxpayer who extends the filing deadline, penalty and interest will be calculated as though the following were due dates:

(a) If an EFT taxable entity is granted an extension until August 15 and pays at least 100% of the tax for the prior year or at least 90% of the tax for the current year, then August 15 will be the due date for any additional tax due.

(b) However, if an EFT taxable entity timely requests an extension until November 15, and remits 99% of the amount due for the current year, then November 15 will be the due date for any additional tax due.

(c) If a taxable entity timely requests an extension until August 15, but does not remit sufficient estimated payments, then May 15 is the due date for 90% of the tax finally determined to be due. August 15 is the due date for the remaining 10% of the tax finally determined to be due.

(d) However, if the taxable entity timely requests an additional extension until November 15, and remits at least 99% of the total tax due before August 15, then May 15 is the due date for 90% of the amount reported as due on or before November 15, August 15 is the due date for 90% of the amount reported as due on or before November 15, and November 15 is the due date for any additional tax due.

Grounds for Denial. The Comptroller will deny an extension if it's the first reporting year (i.e., no report was due in the previous calendar year) or if the report due in the previous calendar year remains unfiled. However, taxpayers filing their initial franchise tax

Back to Table of Contents

reports in 2008 will be allowed to request an extension if they pay at least 90% of the estimated tax for the current year with the extension request.

M. Amended Reports

A taxable entity may file an amended franchise tax report to correct mathematical or other errors. A taxable entity must file an amended franchise tax report if a change in federal tax amounts necessitates a change in state tax reporting.

Amended Returns

If a taxable entity amends its federal income tax return in a manner that would affect its franchise tax liability it must amend its franchise tax report. The amended return is due within 120 days after the entity files the amended federal tax return.

IRS Audits

A taxable entity that is audited by the Internal Revenue Service must also amend its Texas franchise tax return if an adjustment results. The amended return is due within 120 days after the revenue agent report (RAR) becomes final. The Comptroller considers an RAR to be final when the taxpayer has exhausted or waived all administrative appeals with the IRS.[307] The Comptroller does not consider U.S. Tax Court or other federal court proceedings to be part of the administrative appeals process.[308]

Other Audits and Adjustments

If a taxable entity's margin changes as a result of an audit or adjustment by a competent authority other than the Internal Revenue Service, the entity must file an amended franchise tax report within 120 days after the adjustment is final. The Comptroller considers an audit or adjustment to be final when the taxpayer has exhausted or waived all applicable administrative appeals.

N. Exit Tax

The exit tax is an additional franchise tax. Texas law has historically imposed an exit tax on entities ceasing to be subject to the franchise tax. The margin tax contains a similar provision.[309]

Calculation. The additional tax is assessed on the entity's taxable margin for the period beginning on the day after the last day of the preceding margin tax accounting period and ending on the date the taxable entity is no longer subject to the margin tax. The rate equals the same rate the entity would normally pay on its regular annual reports. (0.5% for retailers and wholesalers and 1% for other taxpayers).[310]

O. Total Revenues

The margin computation begins with a taxable entity's revenues. The margin tax revenue computation compiles amounts reported on specific lines of the applicable federal income tax forms for the various types of reporting entities.

The Internal Revenue Service instructions accompanying the federal

307 Comptroller Rule 3.584(f)(2).
308 *Id.*
309 Texas Tax Code § 171.0011(a).
310 Texas Tax Code § 171.0011(b).

forms define specific accounts for income (revenues). In some cases, income and deductions are grouped and reported on the corresponding lines.

The margin tax statute incorporates the Internal Revenue Code as of January 1, 2007 without adjustments made after that date, so taxpayers may still need to make adjustments to their federal tax amounts in reporting Texas margin tax.

Amounts *reportable* as income on federal forms (not just those entered on the forms) are includible in revenues. This explicitly incorporates federal tax law into the margin tax statute by stating that the amounts must comply with federal income tax law. The statute specifically includes in revenues any total revenue reported by a lower tier entity.

Passive Entity Net Income. A taxable entity that owns an interest in a passive entity must include in revenue its share of the passive entity's net income (if the passive entity doesn't file a combined return with the taxable entity).[311] A taxable entity that owns an interest in a passive entity shall only exclude from revenue the share of the passive entity net income that was generated by the margin of another taxable entity.[312]

Annualization of Revenues. The no-tax-due threshold is based on a 12-month (365 day) accounting period. The comptroller has also taken the position that the small business discounts the E-Z computation qualifications are also based on a 12-month (365 day) accounting period.

When the accounting period upon which the report is based is more or less than 12 months, a taxable entity must annualize its total revenue calculation to determine its eligibility for these provisions.[313]

To annualize total revenue, a taxable entity will divide total revenue by the number of days in the period upon which the report is based, and then multiply the result by 365. The following examples are taken from March 2008 issue of the Comptroller's Tax Policy News:

Example. A taxable entity's 2008 franchise tax report is based on the period 09/15/2007 through 12/31/2007 (108 days) and its total revenue for that period is $125,000. The taxable entity's annualized revenue is $422,454 ($125,000 divided by 108 days multiplied by 365). Based on this annualized revenue calculation, the taxable entity does not qualify to file the no-tax-due report because the amount is more than $300,000. It is allowed a discount of 60 percent of tax due because the amount is more than or equal to $400,000 but less than $500,000. It also qualifies to use the E-Z computation because the amount is less than or equal to $10 million.

Example. A taxable entity's 2008 franchise tax report is based on the period 01/01/2006 through 12/31/2007 (730 days) and its total revenue for that period is $1,500,000. The taxable entity's annualized revenue is $750,000 ($1,500,000 divided by 730 days multiplied by 365). Based on this

[311] Texas Tax Code § 171.1011(e).
[312] Texas Tax Code § 171.1011(e).

[313] March 2008 Tax Policy News, available online at: http://cpa.state.tx.us/taxinfo/taxpnw/tpn2008/tpn803.html#issue1.

annualized revenue calculation, the taxable entity does not qualify to file the no tax due report because the amount is more than $300,000. It is allowed a discount of 20 percent of the tax due because the amount is more than or equal to $700,000 but less than $900,000. It qualifies to use the E-Z computation because the amount is less than or equal to $10 million.

P. General Reductions and Exclusions

Not Revenues

Bad Debt Expense. Taxpayers reduce revenue by the amount of bad debts arising in connection with reportable revenues generated during the current or prior periods.[314] In order to exclude bad debts from revenues, the entity must also claims the bad debt expense on its applicable federal income tax return.[315] Bad debt expense is only allowed to the extent the related income was used to compute margin in the current year or a prior taxable year. Bad debt recoveries affect not only the computation of revenues but also the apportionment calculation.

Bad debt recoveries are also gross receipts for apportionment purposes. The apportionment of bad debt recoveries is based upon the nature of the original transaction. If the original transaction would have been apportionable to Texas, the recovery of the related bad debt is apportionable to Texas.

Sales Tax, Etc. Taxpayers exclude from revenue the amount of sales tax, motor fuels tax and other taxes that are included in revenue.[316] Accountants generally don't record sales tax and other trust fund type taxes as revenues. Therefore, this provision appears to apply only in cases where the tax was included in the sales price of a contract and booked as a direct component of the sales price.[317]

Federal & Foreign Revenues

Interest & Dividends on Federal Obligations. Taxpayers exclude from revenue dividends and interest earned from investments in federal obligations.[318]

Federal obligations include stocks and other direct obligations of, and obligations unconditionally guaranteed by, the United States government and United States government agencies. They also include direct obligations of a United States government-sponsored agency.[319]

The margin tax defines "obligation" to include any bond, debenture, security, mortgage-backed security, pass-through certificate, or other evidence of indebtedness of the issuing entity. "Obligation" does not include a deposit, a repurchase agreement, a loan, a lease, a participation in a loan or pool of loans, a loan collateralized by an obligation of a United States government agency, or a loan guaranteed by a United States government agency.[320]

314 Texas Tax Code § 171.1011(c)(1)(B)(i).
315 Texas Tax Code § 171.1011(c)(1)(B)(i).
316 Texas Tax Code § 171.1011(g).
317 *Cf.* Texas Sales Tax Rule §3.286.
318 Texas Tax Code § 171.1011(m).
319 HB 3. Texas Tax Code § 171.101(p)(1)(B).
320 HB 3. Texas Tax Code § 171.101(p)(1)(B).

Back to Table of Contents

The following agencies qualify as United States government agencies:

- Government National Mortgage Association,
- Department of Veterans Affairs,
- Federal Housing Administration,
- Farmers Home Administration,
- Export-Import Bank,
- Overseas Private Investment Corporation,
- Commodity Credit Corporation,
- Small Business Administration,
- and any successor agency.

These are instrumentalities of the United States government whose obligations are fully and explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the United States government.

"United States government-sponsored" agencies include those originally established or chartered by the United States government to serve public purposes specified by the United States Congress but whose obligations are not explicitly guaranteed by the full faith and credit of the United States government. They include

- Federal Home Loan Mortgage Corporation,
- Federal National Mortgage Association,
- Farm Credit System,
- Federal Home Loan Bank System,
- Student Loan Marketing Association,
- and any successor agency.

Foreign Royalties. Foreign royalties also reduce margin tax revenues.[321]

Foreign Dividends. Taxpayers exclude foreign dividends from margin tax revenues.[322]

Foreign Gross-up Income. Taxpayers exclude foreign gross-up income from margin tax revenues.[323] Gross-up income arises when a U.S. corporation receives a dividend from a foreign corporation that has withheld foreign income taxes from the dividend payment. The Internal Revenue Code requires the recipient to include the withheld foreign tax as gross income in determining the federal taxable income for foreign tax credits.[324]

Any amounts which may have been included in taxable income under IRC §78 from dividends received from foreign corporations by domestic corporations choosing the foreign tax credit are subtracted from revenues for purposes of determining taxable margin.

Controlled Foreign Corporation Income. The Internal Revenue Code requires certain U.S. corporations to include in income their pro-rata share of income from controlled foreign corporations (CFCs). The IRC treats CFCs as partnerships for federal income tax purposes.

Flow-Through Revenues

The revised margin tax statute defines flow through revenue exclusions to include net distributive income from

321 Texas Tax Code § 171.1011(c)(1)(B)(ii).
322 Texas Tax Code § 171.1011(c)(1)(B)(ii).
323 Texas Tax Code § 171.1011(c)(1)(B)(ii).
324 IRC §78.

taxable entities treated as partnerships or S corporations for federal tax purposes.[325] This prevents the double taxation that would occur if the state were to tax the revenues on both on the owner's margin tax report and on the flow-through entity's report.

The Comptroller's rules define net distributive income as an "amount of income, gain, deduction *or loss* relating to a pass-through or disregarded entity reportable to the owners for the tax year of the entity."[326]

Income from Disregarded Entities. Taxpayers also exclude revenues attributable to disregarded entities.[327] This helps prevent the double taxation that would occur if the state were to tax the revenues on both on the owner's margin tax report and on the flow-through entity's report.

Schedule C - Special Deductions. Only corporations are allowed to remove the so-called "special deductions" from revenue. Special deductions are reported on Schedule C to the federal Form 1120. The dividends received deductions prevent triple taxation of corporate income.

A. Industry-Specific Revenue Exclusions

These materials address only the industry-specific revenue exclusions that may be relevant to businesses engaged in the oil and gas industry. Other applicable revenue exclusions may exist.

To the extent included in gross revenue, only the following flow-through funds mandated by contract to be distributed to other entities may be excluded from total revenue:

- an amount for certain sales commissions to non-employees,
- the tax basis of securities underwritten, and
- payments to a subcontractor for the design, construction, or repair of improvements on real property or the location of boundaries to real property.[328]

Sales & Real Estate

Sales Commissions. Taxpayers exclude from revenue the amount of sales commissions accrued or paid to nonemployees.[329] This exclusion also includes the payment or accrual of split-fee real estate commissions.[330] A split-fee real estate commission is an earned commission that a real estate broker shares with another licensed broker with whom the broker has cooperated in a real estate transaction.

"Sales Commission" means any form of compensation paid to a person for engaging in an act for which a real estate broker's and sales license is required by Chapter 1101, Occupations Code,[331] and compensation paid to a sales representative by a principal in an amount that is based on the amount or level of certain orders, for or sales of, the principal's product, and that the

325 Texas Tax Code § 171.1011(c)(1)(B)(iv).
326 Comptroller Rule 3.587(b)(7).
327 Texas Tax Code § 171.1011(c)(1)(B)(v).

328 Comptroller's FAQs (Updated 11/23/10).
329 Texas Tax Code § 171.1011(g).
330 *Id.*
331 Texas Tax Code § 171.1011(l)(1)(A).

Back to Table of Contents

principal is required to report on Form 1099.[332]

A "principal" is a person who manufactures, produces, imports, distributes, or acts as an independent agent for the distribution of a product for sale, uses a sales representative to solicit orders for the product; and compensates the sales representative wholly or partly by sales commission.[333]

The Comptroller's rules define a "product" to mean "services, tangible property and intangible property."[334]

Construction. A taxable entity may exclude from revenues certain payments to real estate subcontractors.[335] Payments are excludible if the taxable entity handles the payments in order to provide services, labor or materials for a real estate project.[336] The expenses must be incurred in connection with locating the boundaries of real property or the actual or proposed design, construction, remodeling or repair of real property improvements.[337]

In turn, taxable entities that furnish labor or materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance of real property are considered to be recipients of the revenues and the owners of the labor and materials they contribute to the project.[338]

An architect may exclude subcontracting payments from total revenue where the subcontracting payments are mandated by contract to be distributed to other entities. The Comptroller requires that the architect's contract state that the architect will be contracting with other companies to provide services and that the architect will be collecting reimbursement of those amounts from the client on the subcontractor's behalf. The subcontract payments handled by the architect must be for services, labor or materials in connection with the actual or proposed design, construction, remodeling or repair of improvements on real property or the location of the boundaries of real property.[339]

The Comptroller has interpreted the "mandated by contract" requirement to mean that the contract "must state that the [contractor] will be contracting with other companies to provide service and will be collecting from the client on the subcontractors' behalf ..."[340] The Comptroller's auditors have been looking for specific language in the contract between the general contractor and its customer that allows specific subcontractor costs to be reimbursed.

Oil & Gas

Low-Producing Wells. Taxpayers in the oil and gas industry may exclude certain well income from total revenues during dates that the price of oil or gas sinks below certain specified levels.

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332 Texas Tax Code § 171.1011(l)(1)(B).
333 Texas Tax Code § 171.1011(l)(2).
334 Comptroller Rule 3.587 (b)(10).
335 Texas Tax Code § 171.1011(g)(3).
336 *Id.*
337 *Id.*
338 Texas Tax Code § 171.1012(i).
339 Comptroller Letter No. 200809217L. (September 23, 2008).
340 Comptroller Letter No. 200809217L (Jennifer Speccio – Sept. 23, 2008). (Exhibit D).

Q. Revenue Consistency

Affiliated Groups. Entities that are members of affiliated groups may not exclude from revenue the payments made to other members for:

- sales tax
- other trust fund taxes
- sales commissions
- tax basis of securities and loans sold, including underwritten securities
- payments to subcontractors for real estate construction and remodeling
- loan principal repayments received by lending institutions
- payments eligible for the attorney's exclusion
- pharmacy co-op flow-through funds[341]

Accounting Consistency. Any amount excluded from revenue may not be included in the calculation of COGS or compensation.[342] This prevents double deductions for the same amount.

The revised margin tax statute specifies that gross proceeds from sales of loans or securities that are treated as inventory for federal tax purposes are considered gross receipts for calculating revenues and apportionment. This is true regardless of whether the lender qualifies for the interest deduction under the COGS computation.

R. Cost of Goods Sold Deduction

The purpose of the cost of goods sold ("COGS") deduction is to match revenue with the direct and indirect costs associated with acquiring and producing goods. The federal income tax rules require businesses to capitalize these costs to inventory and deduct them when it sells the goods.

In order to determine whether to deduct COGS, a taxpayer must consider the following three questions:

Who Owns the Goods? The statute directs taxpayers to weigh the benefits and burdens of ownership that vest with the entity.[343] Benefits may include income-producing capacity, interest and rights to proceeds. Burdens may include insurance payments, property tax liabilities and risk of loss.

> **Audit Alert:** Taxpayers claiming to own goods should expect the Comptroller's auditor to conduct third-party verification. (e.g. vendor contracts, bills of lading, county property records, insurance providers, tax appraisal district records for real and personal property, sales and use tax permit records, etc.)

Combined Groups. A combined group member may claim COGS deductions if the goods for which costs are incurred are owned by a member of the combined group.[344]

General Contractors. Many developers hire general contractors to erect buildings and improvements. General contractors may treat their own material and labor purchases as COGS.[345] A general contractor is the "owner" of the installation labor and materials even if the developer holds title to the real property. Payments a general contractor makes to its

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341 Texas Tax Code § 171.1011(h).
342 Texas Tax Code § 171.1011(j).
343 Texas Tax Code § 171.1012(i).
344 *See* HB 3928.
345 Texas Tax Code § 171.1012(i).

Back to Table of Contents

subcontractors are excluded from both revenues and COGS.[346] Oil and gas drilling is considered real estate construction for franchise tax purposes

Subcontractors. A taxable entity that furnishes labor or materials to a project for the construction, improvement, remodeling, repair or industrial maintenance of real property is an owner of that labor and materials and may include the costs in COGS.[347]

Example. Cabinetry – A cabinetmaking entity that works as a subcontractor for a real estate developer would be eligible to deduct the cost of the wood, nails, hinges, glass, drawer pulls, and other materials incorporated into the real estate. It would also be eligible to deduct payments made to its workers for their time spent on the project.

The Comptroller has interpreted "post-production direct costs" to exclude the costs of installation services performed after the manufacturing or construction has concluded. However, installation performed during construction of real property is an includible COGS. This position appears somewhat inconsistent, since the statute specifically references "construction, improvement, remodeling, repair, or industrial maintenance of real property," which appears to allow for the deduction of costs associated with real property even after the initial real estate construction is complete.

Federal Government Contracts. As a general rule, businesses retain title and risk of loss of goods in production until the project is complete and the customer receives the goods. However, under most federal contracts, businesses furnishing goods to the federal government transfer ownership before they complete the work. Under the general ownership rules, federal government contractors would not "own" the goods and would thus be ineligible to deduct the related costs.

In order to remedy this disparity, the statute treats federal government contractors as owners of the goods manufactured or acquired.[348] This treatment extends to subcontractors working on the project.[349] The rule applies even if the applicable Federal Acquisition Regulation requires title or risk of loss to transfer to the federal government before manufacturing or production is complete.[350]

Does the Entity Sell "Goods"? Goods are "real or tangible personal property sold in the ordinary course of business of a taxable entity."[351] An

[346] The margin tax provides that taxable entities may exclude certain flow-through funds from revenue. Eligible flow-through funds include "subcontracting payments handled by the taxable entity to provide services, labor, or materials in connection with the actual or proposed design, construction, remodeling, or repair of improvements on real property or the location of the boundaries of real property." See Texas Tax Code § 171.1011(g).

[347] Texas Tax Code § 171.1012(i) "A taxable entity furnishing labor or materials to a project for the construction, improvement, remodeling, repair or industrial maintenance ... of real property is considered to be an owner of that labor or materials and may include the [allowable] costs ... in the computation of cost of goods sold."

[348] Texas Tax Code § 171.1012(i).

[349] *Id.*

[350] Texas Tax Code § 171.1012(i).

[351] Texas Tax Code § 171.1012(a)(1).

Back to Table of Contents

entity must sell *goods* in order to deduct COGS.

Tangible Personal Property. Tangible personal property is "personal property that can be seen weighed, measured, felt, or touched or that is perceptible to the senses in any other manner."

Animals, Crops and Timber. Animals, crops and timber are "goods" for purposes of excluding compensation paid to undocumented workers.[352] Crops and timber generally fit the definition of "real property." For COGS purposes, "goods" includes the "husbandry of animals, the growing and harvesting of crops, and the severance of timber from realty."[353]

Media. Tangible personal property includes films, sound recordings, videotapes, books and other media intended to be mass-distributed in a form that will not be substantially altered.

Computer Programs. Tangible personal property also includes computer programs, as defined in the sales tax law. A computer program is "a series of instructions that are coded for acceptance or use by a computer system and that are designed to permit the computer system to process data and provide results and information. The series of instructions may be contained in or on magnetic tapes, punched cards, printed instructions, or other tangible or electronic media."[354]

Real Property. The statute includes "real property" in the definition of "goods" but doesn't define it. Black's Law Dictionary defines "real property" as "land and anything growing on, attached to, or erected on it, excluding anything that may be severed without injury to the land. ..."[355]

TV, Radio and Film. Tangible personal property includes live and pre-recorded TV and radio programs (without regard to distribution method or the medium).[356] Entities principally engaged in film or television production or broadcasting or the distribution of live and pre-recorded TV and radio programs who elect to deduct COGS deduct:

- The costs described below that are incurred in relation to the property;
- Depreciation, amortization and other expenses directly related to acquisition, production or use of the property; and
- Expenses for rights to broadcast property.

Caution: The following items are not goods:

Intangibles. Intangible items are not "goods."[357] Intangible property includes trademarks, patents, accounts receivable, contract rights, stocks & bonds, partnership interests, etc.

Services. Services are not "goods."[358] Therefore, service providers are ineligible to deduct the costs they incur in providing their services. Where a transaction involves the sale of both tangible personal property and a service,

[352] Texas Tax Code § 171.1012(e)(14)(B).
[353] Texas Tax Code § 171.1012(e)(14)(B).
[354] Texas Tax Code § 151.0031.
[355] Black's Law Dictionary, 8th Ed., West Group (2004), page 1254.
[356] HB 3928.
[357] Texas Tax Code § 171.1012(a)(3)(B).
[358] Texas Tax Code § 171.1012(a)(3)(B).

Back to Table of Contents

the COGS deduction is available only to the extent the costs pertain to the sale of the tangible personal property.[359]

For Texas franchise tax purposes, "goods" means "real or tangible personal property sold in the ordinary course of business of a taxable entity."[360]

"Production" includes "construction, installation, manufacture, development, mining, extraction, improvement, creation, raising, or growth."[361]

Taxpayers selling services are generally ineligible for the COGS deduction.[362]

Example. Entities engaged in the transportation industry (e.g. trucking companies that transport fuel) are not eligible to subtract COGS for their transportation services.[363]

Example. In order for the COGS deduction to apply, a real estate subcontractor must actually be working on the improvement to realty. Since oil and gas drilling is considered real estate construction for franchise tax purposes, this is relevant to the oil and gas industry. An architecture firm hired to provide all of the design work for a construction project has a contract that says it will subcontract out the engineering work on this project. Based on this contractual provision, the architecture firm is allowed to exclude from revenue the amounts paid to an engineering firm for work on this project. The architecture firm, however, only produces the plans for the construction project. The architecture firm does not construct, improve, remodel or repair the property (physically work on the real property and effect a change to that property). As a result, the architecture firm is not eligible to take a COGS deduction for its services.[364]

Mixed Transactions. The Comptroller's rules clarify how the COGS deduction applies to entities that engage in mixed transactions, which include both a transfer of tangible personal property and a service. If a transaction contains elements of both a sale of tangible personal property and a service, the Comptroller has stated that the taxable entity may only subtract as COGS the costs otherwise allowed by this section in relation to the tangible personal property sold. The Comptroller's responses to taxpayers' frequently asked questions provide the following examples:

<u>Example 1</u>. Oil Change Services - a taxable entity providing an oil change may include in its COGS computation only the cost of the oil filter and oil that is that is included in the performance of the service. No labor costs would be included as part of COGS.

<u>Example 2</u>. Crop Duster - a taxable entity that provides crop dusting services may include in COGS the cost of chemicals used in the performance of the service as part of COGS. Aviation fuel, labor, airplane rental, etc. would not be allowed as part of COGS.

<u>Example 3</u>. Veterinary Service - a taxable entity that performs veterinary

359 Comptroller Rule 3.588(c)(6).
360 Texas Tax Code § 171.1012(a)(1).
361 *Id.* at § 171.1012(a)(2).
362 Texas Tax Code § 171.1012(a)(3).
363 Tax Policy News, September 2010.
364 Tax Policy News, August 2010.

services may include in COGS the pharmaceuticals and other medical (vet) supplies. No labor costs or fees would be included.

Example 4. Auto Body Shop - an auto body shop offers the service of car repair and in the process of the repair, replaces some of the car's parts. If the auto body shop elects to use the COGS to determine margin, the shop can only deduct the cost of the car parts. The labor related to the repair of the car is not allowed as a COGS.[365]

What Amount is Deductible? In general, the entity includes the following in COGS:

- All direct costs of acquiring or producing the goods;
- Indirect or administrative costs allocable to acquiring or producing the goods; and
- Certain other indirect costs.

Direct Costs. Direct costs include the costs of acquiring, producing and processing goods. They also include certain other costs that one wouldn't usually consider direct acquisition and production costs, such as geological and geophysical costs, and research and development costs.[366]

Acquisition Costs

- Inbound Transportation Costs. These are costs attributable to freight and other inbound delivery of items such as goods, component parts, and raw materials.
- Electricity Acquisition. The cost of acquiring electricity sold is includible in COGS.

Production Costs

- Direct Labor. The statute does not define direct labor costs. This likely includes wages and cash compensation and the cost of benefits incurred for both employee and non-employee workers involved in the acquisition and production of goods.

The Comptroller has stated in her responses to taxpayers' frequently asked questions that all direct labor costs, including amounts reported on IRS Form 1099-MISC nonemployee compensation, are part of COGS when calculating margin.

Labor to install tangible personal property outside of the manufacturing process, unless part of "construction, improvement, remodeling, repair or industrial maintenance of real property," is not allowed as part of the COGS deduction. See Rule 3.588(b)(7).

A client company of a staff leasing company may include in COGS the total amount paid to a staff leasing company for assigned employees to the same extent the business could have included the amount in COGS if the client company had employed the assigned employees directly.

- Electricity Production. This is the cost to produce electricity sold.
- Component Materials. These are costs for materials that are an integral part of the goods produced.
- Consumed Materials. These are materials consumed in the ordinary

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365 Tax Policy News, July 2010.
366 Texas Tax Code § 171.1012(c).

Back to Table of Contents

course of performing production activities. Production activities include construction, installation, manufacturing, development, mining, extraction, improvement, raising or growth. Mining and extraction pertain to natural resources. Raising and growth pertain to agricultural activities.

Inventory Processing Costs

- Storage Costs. This includes costs of carrying, storing or warehousing property.
- Handling Costs. This includes costs attributable to processing, assembling and repackaging goods. The Comptroller's responses to taxpayers' frequently asked questions clarify that a store stocker's labor is considered a handling cost and included in the COGS deduction.

Facilities and Equipment Costs

- Depreciation, Depletion and Amortization. Taxpayers may deduct these costs to the extent they're associated with and necessary for producing goods. This includes IRC § 197 recovery costs of goodwill and certain other intangibles.[367] The revised margin tax statute specifies that depreciation, depletion and amortization deductions are limited to the amounts reported on the entities' federal income tax returns.[368] Bonus depreciation under IRC § 179 is limited to the amounts as of January 1, 2007, without subsequent changes to the Internal Revenue Code. The Comptroller's position is that depreciation is limited to the amount reported on the federal income tax return for which the franchise tax report is based, to the extent associated with and necessary for the production of goods.[369]
- Rental Expenses. This includes costs of renting or leasing equipment, facilities or real property directly used for the production of goods.
- Repair and Maintenance. This includes the costs of repairing and maintaining equipment, facilities or real property used directly for the production of the goods.

2011 Update. A pass-through entity, such as a partnership or S corporation, may include in COGS the oil and gas depletion it calculates and separately reports to its owners for federal tax purposes. Since the entity includes the allowable depletion in its COGS, the Comptroller does not allow the owners of a pass-through entity to include the depletion reported to them in their in COGS.[370]

Other Costs

- Research & Development. These are costs attributable to research, experimental, engineering and design activities directly related to the production of the goods. This includes all research or experimental expenditures described by IRC § 174.[371]
- G&G Costs. This includes geological and geophysical costs incurred to identify and locate property that has the potential to produce minerals.

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367 Texas Tax Code § 171.1012(c)(6).
368 HB 3928.
369 Comptroller Letter No. 200810200L (October 17, 2008).
370 *See* Rule 3.588(d)(6) and Comptroller's FAQs (Added 09/09/2011).
371 Texas Tax Code § 171.1012(c)(9).

- Pollution Control, Intangible Drilling and Dry Holes. The statute includes pollution control equipment and intangible drilling and equipment rental associated with dry hole costs in the "cost of renting or leasing equipment, facilities, or real property directly used for the production of the goods."[372] It also includes repairs and maintenance of pollution control devices in COGS.[373]
- Transaction Taxes. These are taxes paid in relation to acquiring or producing any material, or taxes paid in relation to services that are a direct cost of production. (e.g., sales and use tax, excise tax, or property tax on inventory)

2011 Update. The Comptroller's position is that partnerships may not elect to amortize intangible drilling costs (IDC) over 60 months.[374] Since IDCs are a part of the COGS deduction, the Comptroller requires a taxable entity that elects to capitalize its allowable COGS under § 171.1012(g) to capitalize those costs in the same manner and to the same extent they are capitalized on the taxable entity's federal income tax return. For federal tax purposes the 60-month IDC amortization election is made at the partner level rather than by the partnership, so a partnership must expense its IDCs in the year incurred for the COGS deduction.

Indirect Costs. Taxable entities may subtract indirect or administrative overhead costs as costs of goods sold. The indirect costs must be allocable to the acquisition or production of goods.

372 Texas Tax Code § 171.1012(c)(7).
373 Texas Tax Code § 171.1012(c)(8).
374 Comptroller FAQs (added 01/26/11).

This includes all mixed service costs:

- Security Services. This may include fees paid for security services to guard a facility where goods are being produced or stored in inventory.
- Legal Services. This may include fees a manufacturing plant incurs for legal services in connection with environmental cleanup litigation.
- Data Processing Services. This may include fees incurred for data processing services for inventory maintenance and the allocable portion of accounts payable and payroll processing.
- Accounting Services. This may include the cost of accounting services related to manufacturing or inventory operations, such as cost accounting, accounts payable, disbursements and payroll.
- Personnel Operations. This may include the allocable costs of recruiting, hiring, relocating, assigning and maintaining employee personnel records for employees involved in manufacturing or inventory operations.
- General Financial Planning Costs. This may include financial planning costs incurred in connection with planning for manufacturing or inventory operations.
- General Financial Management Costs. This may include financial management costs incurred in connection with cost accounting for manufacturing or inventory operations.

Note: It's unclear how taxpayers would prove indirect costs are allocable to acquiring or producing goods. The allowable amount is capped at four percent of the total indirect or administrative overhead costs, so many entities are likely to simply deduct four percent of total indirect and administrative overhead.

4% Limitation. The indirect costs may not exceed four percent (4%) of the taxable entity's total indirect or administrative overhead costs, including all mixed service costs.

Other Costs. The margin tax also allows entities to include other related costs in COGS if they are incurred in relation to the taxable entity's goods:[375]

Production Costs

- Utilities. This likely includes electricity, gas, water and other utilities used in the production of goods.
- Quality Control. This includes the costs of replacing defective components pursuant to standard warranty policies, costs of inspections directly allocable to the production of goods, and costs of repairing and maintaining goods held for sale.[376]

Costs Incurred Outside Production

- Pre-Production Direct Costs. If property is held for future production, preproduction direct costs are includible in COGS to the extent they're allocable to the property. This includes the cost of purchasing the goods, storing the goods and handling the goods.
- Post-Production Direct Costs. This includes storage, handling and other direct post-production costs allocable to the property.

375 Texas Tax Code § 171.1012(d).
376 Texas Tax Code § 171.1012(d)(9).

Back to Table of Contents

> **Note:** The Comptroller has interpreted "post-production direct costs" to exclude the costs of installation services performed after the manufacturing or construction has concluded. However, installation performed during construction of real property is an includible COGS.

Cost of Waste

- Spoilage and Abandonment. This includes costs of rework labor, reclamation and scrap.
- Deterioration. This includes diminution of quality, character or value of the goods held in inventory.
- Obsolescence. This is the cost of declining usefulness of goods held in inventory because they have become outmoded or outdated.

Insurance Costs

- Facilities Insurance. COGS includes the cost of insurance on a plant or facility, machinery, equipment or materials used in the production of the goods.
- Inventory Insurance. COGS includes the cost of insurance on produced goods held in inventory.

Intellectual Property Costs

- Licensing and Franchise Costs. These are costs and fees incurred in securing the contractual right to use a trademark, corporate plan, manufacturing procedure, special recipe or similar right directly associated with the goods produced. (e.g., the license and secret recipe to produce Coca-Cola®)

Section 179 Expense Limits. The Section 179 expense limit is based on the Internal Revenue Code as of January 1, 2007, and is not affected by any changes made by federal law after that date. A Section 179 expense deduction is only allowed for taxable entities that elect to use COGS to compute margin. Only taxable entities that sell real or tangible personal property in the ordinary course of business are eligible to use the COGS deduction. Allowable costs include depreciation and Section 179 expense deductions that are related specifically to equipment used in the production of goods.

Allowable costs include depreciation and IRC Section 179 expense deductions that are related specifically to equipment used in the production of goods.[377] Since the Texas franchise tax calculation is tied to the IRC Section 179 in effect as of Jan. 1, 2007, the changes in the Section 179 expense deduction allowed by the Small Business and Work Opportunity Act of 2007 and the American Recovery and Reinvestment Act of 2009 do not apply to franchise tax reports.

The following limits apply for Section 179 expense from the IRC as it existed on Jan. 1, 2007, that can be included in the COGS deduction for Texas franchise tax reports:

Franchise Tax Report Year	For Accounting Years Ending in	Amount
2008	2007	$112,000
2009	2008	$115,000
2010	2009	$120,000
2011*	2010*	$ 25,000

* and beyond

377 Tax Policy News, February 2010.

Back to Table of Contents

S. Nondeductible Costs

The following items are specifically excluded from COGS for purposes of calculating the Texas margin tax:

Pre-Production Costs

- Bidding Costs. Costs incurred in the solicitation of contracts are not deductible. This is true regardless of whether the contracts are ultimately awarded to the taxable entity.

Post-Production Costs

- Selling Costs. Marketing, employee sales commissions, and other costs of selling goods (including employee expenses incurred in connection with sales of goods) are not deductible.
- Advertising Costs. Costs incurred to attract public attention to a product or business are not deductible.
- Distribution Costs. Outbound transportation costs and other distribution costs are not deductible.
- Rehandling Costs. Costs associated with restocking returned items and preparing them for sale are not deductible.

Non-Production Costs

- Non-Production Rental Costs. Costs of renting or leasing equipment, facilities or real property are not deductible if they are not used for the production of goods.
- Idle Facility Expenses. Expenses incurred due to maintenance shutdowns or other idle facility time are not includible in COGS.
- Strike Expenses. Costs associated with hiring employees to replace striking personnel are not includible in COGS. However, the wages of replacement personnel, the costs of security and the legal fees associated with settling strikes are includible if they can be allocated to the goods being produced.

Administrative Costs

- Interest. Interest on debt incurred or continued during the production period to finance the production of goods is not deductible.

Exception. Lending institutions offering loans to the public may include interest expense in COGS.

The revised margin tax statute changed the definition of "lending institutions" that are eligible to deduct interest as part of their COGS. In order to qualify as a lending institution, a business must be regulated by, registered with, or licensed by a regulatory body. The statute contains a list of examples.[378] The statute specifies that entities providing financing to unrelated parties solely for agricultural production qualify as lending institutions. However, pawn shops cannot deduct interest like other lending institutions can.[379]

The Comptroller has also stated that a motor vehicle sales finance company is not considered to be offering loans to the public unless it offers loans to customers to finance property other than property

378 HB 3928, amending Texas Tax Code § 171.0001 (10).

379 *See id.* Pawn shops are sellers of used merchandise under SIC category 5932.

Back to Table of Contents

that it or an affiliated entity sells in the ordinary course of business.[380]

- Income Taxes. Local, state, federal, and foreign income taxes are not includible in COGS. This includes franchise taxes a taxable entity pays based on its income.

Officers' Compensation. Payments to persons who manage or direct the daily operations of a business are not deductible as COGS. The Comptroller declined to provide a rule allowing such amounts to be includible if the officer or director performed substantial direct labor in connection with the acquisition or production of goods.

Government Facilities. The costs of operating certain federal government facilities are not includible in COGS. This includes the costs of operating facilities located on property owned or leased by the federal government and managed or operated primarily to house members of the United States armed forces. These aren't includible in COGS because the income reported for federal purposes from those facilities isn't included in the determination of revenue.[381]

Undocumented Workers. Compensation paid to undocumented workers to produce goods is not includible in COGS. Undocumented workers are persons who are not lawfully entitled to be present and employed in the United States.

Partnership Contributions. A special margin tax rule allows a COGS deduction for a contribution to a partnership in which the taxable entity owns an interest. The cost is eligible for inclusion if the contribution is used to fund activities that would otherwise be treated as COGS for the partnership. The deduction is allowed only to the extent that the costs are related to goods distributed to the taxable entity as goods-in-kind in the ordinary course of production activities rather than being sold.[382]

T. Arms-Length Requirement

Payments made by one member of an affiliated group to another that is not included in a *combined* group may be subtracted as a COGS only if it the transaction is conducted at arm's length.

The Comptroller considers arms-length to be "The standard of conduct under which entities that are not related parties and that have substantially equal bargaining power, each acting in its own interest, would negotiate or carry out a particular transaction."

U. Capitalizing COGS

Taxable entities must determine COGS in accordance with federal income tax methods, as adjusted for margin tax. The revised margin tax statute states that entities electing to deduct COGS for margin tax may either capitalize costs on their federal tax returns or expense them.

A taxable entity that is subject to IRC Sections 263A, 460, 471 or 472 may elect to capitalize or expense the costs allowed for franchise tax reporting

380 Comptroller FAQs (Updated 09/09/11).

381 *See* Texas Tax Code §§ 171.1012(e)(13) *and* 171.1011(q).

382 *See* HB 3. Texas Tax Code § 171. 171.1012 (f)(13).

in computing COGS. A taxpayer makes the election to capitalize or expense COGS by filing its franchise tax report using one method or the other. The election is effective for the entire period upon which the report is based and may not be changed after the due date of the report.

A taxable entity that elects to capitalize allowable costs for COGS must capitalize all allowable costs for franchise tax reporting that it capitalized for federal tax purposes. Any allowable costs for franchise tax reporting that were not capitalized for federal tax purposes must be expensed in computing COGS. Any costs not allowed under Texas Tax Code § 171.1012 may not be included in COGS even if the entity capitalized the cost for federal tax purposes.

Taxable entities electing to capitalize costs on federal tax returns must capitalize each cost allowed as COGS that it capitalized on its federal tax return. Entities that later elect to expense costs on their federal tax returns may not later deduct costs for margin tax that were in ending inventory from a previous report.

Taxable entities electing to expense COGS on their federal tax returns may deduct for margin tax allowed costs incurred during the period on which margin tax is based. They may not deduct costs incurred before the first day of the period. Taxable entities that initially elect to expense COGS and later elect to capitalize those costs may capitalize costs already expensed on a previous margin tax report.

V. Compensation Deduction

The compensation deduction contains two elements:

- Wages & Cash Compensation
- Benefits

"Wages and cash compensation" includes payments to eligible persons, including net distributive income paid to partners or owners, and stock awards and stock options deducted for federal income tax purposes.[383] This amount is capped at a maximum of $330,000 of wages and cash compensation per individual starting January 1, 2012.[384]

For 2008 and 2009, the wages and cash compensation component of the compensation deduction was limited to $300,000 per person, pro-rated, for the annual period for which margin is calculated. The per person compensation deduction increased to $320,000 beginning January 1, 2010 and to $330,000 beginning January 1, 2012. This amount will continue to be indexed biennially.

"Benefits" includes the cost of all benefits provided to eligible persons.[385] This amount is uncapped.

W. Eligible Persons

Taxpayers may deduct wages and cash compensation and benefits paid only to certain classes of individuals:

- Employees
- Officers
- Directors

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383 Texas Tax Code § 171.1013(b)(1).
384 For prior years the limit was $300,000.
385 Texas Tax Code § 171.1013(b)(2).

Back to Table of Contents

- Owners
- Partners

Payments to independent contractors are not deductible as compensation.

Eligible payments to management companies and staff leasing companies are deductible because these entities are treated as agents of the employers.

The statute defines a staff leasing services company by reference to the Labor Code. The Labor Code defines staff leasing as an arrangement by which a license holder's employees are assigned to work at a client company. The license holder and client company share employment responsibilities. The employee's assignment is intended to be of a long-term or continuing nature, rather than temporary or seasonal in nature. A majority of the work force at the client company's worksite or a specialized group within that work force consists of the license holder's assigned employees. The term includes professional employer organization services.

2011 Update. The District Court case of *Taylor & Hill, Inc. v. Combs,*[386] considered whether a business classified as a staff leasing could take the COGS deduction, or in the alternative whether a Tax Code §171.101(d) election to do so precluded post-audit use of the compensation deduction to calculate margin. The District Court determined that since it was a staff leasing company it was required to take the compensation deduction. Therefore, the compensation deduction was allowed.

[386] Travis County District Court Cause No., D-1-GN-10-004429.

In its examination of the original 2009 franchise tax report, the Comptroller asserted that Taylor & Hill, a registered professional engineering firm, was not eligible to compute margin by deducting COGS. The auditor denied the COGS deduction and assessed tax by applying the 70 percent of total revenue calculation. Taylor & Hill paid the assessment under protest and filed suit to recover the additional tax paid for the 2009 report year.

Taylor & Hill asserted that it is a professional and engineering staffing firm serving the oil and gas industry and that it temporarily assigns its employees to its clients to supplement its clients' workforce in special situations. Taylor & Hill receives payments from its clients in exchange for the labor provided by its employees. These payments include reimbursement for wages, payroll taxes on those wages, employee benefits and worker's compensation benefits for the employees that it assigns to the client companies.

The judge ruled that Taylor & Hill is a temporary employment service and is therefore entitled to take the revenue exclusion for staff leasing companies and to use compensation (as required by Tax Code Section 171.101(b)) to compute its taxable margin on its 2009 Franchise Tax Report.

X. Wages & Cash Compensation

The deduction for "wages and cash compensation" paid to a qualified individual is a sum of the individual's wages and tips reported on the Form W-2, net distributive income, and the value of stock awards and stock options. This deduction is capped at $330,000 per

Back to Table of Contents

individual beginning January 1, 2012.[387] The limit applies to the aggregate amount that various members of a combined group may pay to individuals. No deduction is allowed for wages and cash compensation paid to undocumented workers.

Computing wages and cash compensation starts with the company's Federal Forms W-2. Box 5, "Medicare Wages and Tips" determines the base amount of wages and cash compensation for each employee.[388] This often equals wages, tips, and other compensation reported in Box 1.[389] Box 5 of Form W-2 generally reports:

- Wages, bonuses, and tips
- Noncash payments, including taxable fringe benefits
- Certain payments for non-job-related education expenses
- Employer's payment of employee's share of taxes[390]

The "Medicare wages and tips" box also includes the employee's elective deferrals to certain qualified cash or deferred compensation plans, such as 401(k)s. However, an employer may not include the employer's share of employment taxes in compensation.

Net Distributive Income. The margin tax statute allows businesses that compensate their partners-employees in whole or in part through partnership distributions to take a compensation deduction for those payments. This provision is likely designed to accommodate professional service providers, such as engineering, accounting and law firms.

The Comptroller's instructions to the margin tax reports state that the amount of net distributive income for the calculation of compensation is the amount of income, gain, deduction, or loss relating to a pass-through entity or disregarded entity reportable to the owner for the tax year of the entity regardless of whether an actual distribution was made.

To compute Net Distributive Income from a partnership:
From IRS Form 1065 K-1, add boxes 1, 2, 3, 4, 5, 6a, 7, 8, 9a, 10 and 11. Subtract from that result the sum of boxes 12, 13 and 16, Code L (Foreign taxes).

To compute Net Distributive Income from an S corporation:
From IRS Form 1120S K-1, add boxes 1, 2, 3, 4, 5a, 6, 7, 8a, 9 and 10. Subtract from that result the sum of boxes 11, 12 and 14, Code L (Foreign taxes).

In general, for federal tax law and under regular state law, partners aren't considered to be employees of the partnership. This is evident in the fact that federal employment tax law requires each partner to pay the full amount of the self-employment taxes on his or her share of the partnership's income.[391]

For margin tax purposes, "Wages and Cash Compensation" includes net

387 The cap for prior years was $300,000.
388 Texas Tax Code § 171.1013(a).
389 In a few unusual situations, the type of wages subject to Medicare tax can differ from the amount subject to income tax withholding. For a helpful chart of these differences, see Section 15 of IRS Circular E, "Employer's Tax Guide."
390 IRS Instructions for Form W-2, p. 9.

391 *See* Prentice Hall, page 2-4.

distributive income from the following sources:

(1) taxable entities treated as partnerships for federal income tax purposes;[392] and

(2) limited liability companies and corporations treated as S corporations for federal income tax purposes.[393]

The Comptroller's rules define "net distributive income" as "[t]he net amount of income, gain, deduction, *or loss* relating to a pass-through entity or disregarded entity reportable to the owners for the tax year of the entity."[394] The Comptroller has clarified that guaranteed payments may be included in the computation of net distributive income.

The Comptroller revised Rules 3.587 and 3.589 to state that net distributive income that is subtracted from total revenue may not be included in the determination of compensation. For franchise tax reports due on or after January 1, 2008, Texas Tax Code § 171.101 allows a taxable entity to elect to deduct compensation from total revenue to determine its taxable margin.[395] Compensation is defined to include (among other things) net distributive income ("NDI") from partnerships, trusts, corporations and limited liability companies treated as S corporations for federal income tax purposes and limited liability companies treated as partnerships for federal income tax purposes as long as the NDI is received by a natural person.[396] Comptroller Rule 3.589 defines NDI as the net amount of income, gain, deduction, or loss relating to a pass-through entity or disregarded entity reportable to the owners for the tax year of the entity.[397]

The Comptroller's position is that a pass-through or disregarded taxable entity that elects to deduct compensation must include negative NDI (*i.e.*, a loss) in its computation of the compensation deduction. This would effectively involve subtracting a negative number in computing an entity's compensation deduction amount. The potential consequence of this action would be to increase the entity's taxable margin.[398]

Natural Persons Only.

In order to qualify for the compensation deduction, the recipient of the net distributive income must be a natural person.

The revised franchise tax statute defines a "natural person" as "A human being or the estate of a human being." Purely legal entities, such as a corporations, limited liability companies, partnerships, or trusts, are not natural persons, even though they may possess

[392] Texas Tax Code § 171.1013(a)(1).
[393] Texas Tax Code § 171.1013(a)(2).
[394] Proposed Comptroller Rule 3.589(b)(5).
[395] Texas Tax Code § 171.101(a)(1)(B)(ii)(b).

[396] Texas Tax Code §§ 171.1013(a)(1) and (2).
[397] Comptroller Rule 3.589(b)(5).
[398] The Comptroller's staff acknowledged (in a joint committee meeting between the Comptroller, the TSCPA and the State and Local Tax Committee of the State Bar Tax Section on June 13, 2008) that the consequence of this interpretation would mean that a pass-through or disregarded entity with negative NDI that elects to deduct compensation would have to reduce its compensation by the distributive share of negative NDI allocable to its natural person owners (*i.e.*, because subtracting negative NDI results in a positive amount).

Back to Table of Contents

rights, privileges or responsibilities with respect to payments that would otherwise be considered compensation, in a general sense.

No Undocumented Workers. A taxable entity may not deduct wages or cash compensation paid to "undocumented workers." The statute defines "undocumented worker" as a person who is not lawfully entitled to be present and employed in the United States.[399]

Y. Benefits

The margin tax statute also allows an entity to deduct "the cost of all benefits the taxable entity provides its officers, directors, owners, partners, and employees."[400] The revised margin tax statute specifies that benefits are limited to the amount deductible for federal income tax purposes.[401]

The statute doesn't specifically define "benefits," but provides the following list of items that may be deducted as benefits:

- Workers' compensation benefits
- Health care
- Employer contributions made to employee's health savings accounts
- Retirement

These benefits are deductible as compensation to the extent they are deductible for federal income tax purposes.

[399] Texas Tax Code § 171.1013(c-1).
[400] Texas Tax Code § 171.1013(b)(2).
[401] HB 3928, amending Texas Tax Code § 171.1013 (b)(2).

Z. Not Benefits.

The following items are not benefits:

Wages and Cash Compensation. If an item is already included in the calculation of wages and cash compensation, it may not be included twice, even though it may also meet the definition of a "benefit." This includes health care and other benefits required to be reported on Form W-2, Box 5, "Medicare Wages and Tips."

Employee Discounts. The Comptroller's rules don't allow a taxable entity to include in benefits any amounts associated with discounts on the entity's own merchandise for its employees, officers, directors, owners, or partners that aren't available to other customers. Comptroller Rule 3.589(e)(2)(B).

Employer's Share of Payroll Taxes. A taxable entity may not deduct the employer's share of FICA, federal unemployment taxes, state unemployment taxes, social security and other employment taxes. Only the employee's portion is includible, as a part of wages and cash compensation, but not as a benefit.

Working Condition Fringe Benefits. A taxable entity may not deduct expenses incurred in connection with working condition fringe benefits. Working condition fringe benefits are those provided in order for employees to be able to perform their work. This includes benefits such as travel reimbursements, use of a company car for business purposes, job-related education expenses, and similar benefits.

Employee's Share. The deduction also doesn't include employee contributions. This includes employee contributions associated with health care plans (e.g., deductibles and co-pays), employee contributions in connection with retirement accounts, employee payments made to exercise stock options, etc.

AA. Health Care Incentives

The revised margin tax statute includes health care incentives for small employers electing to deduct compensation. Small employers are defined as "person[s] who employed an average of at least two employees but not more than 50 eligible employees on business days during the preceding calendar year and who employs at least two employees on the first day of the plan year. The term includes a governmental entity .... For purposes of this definition, a partnership is the employer of a partner."[402]

In addition to subtracting health care benefits a qualifying small business may also subtract:

- 50% of the cost of health care benefits provided for the first 12-month period on which margin is based
- 25% of the cost of health care benefits provided to its employees for the second 12-month period on which margin is based

[402] Insurance Code § 1501.002 – Health Insurance Portability Act.

In order to qualify for the additional deduction:

(1) The employer must be a "small employer;"

(2) The employer must not have previously provided health care benefits to any of its employees during the calendar year preceding the beginning date of its reporting period; and

(3) The employer must provide health care benefits to all of its employees during the period it claims the additional deduction.

BB. Military Compensation

The statute provides a special deduction for entities that have paid compensation to individuals serving on active duty as members of the U.S. armed forces.[403]

An entity may deduct compensation paid to these individuals even if it elects to deduct COGS. Also, if an entity takes the compensation deduction, it appears that it can deduct the compensation paid to these individuals twice: once under the compensation deduction, and once under the additional deduction. No deduction is allowed if the entity chooses the 30% of total revenue deduction.

Compensation paid to military workers includes both wages and cash compensation subject to the cap, plus benefits computed using the rules for the compensation deduction.

The compensation is limited to the amount paid to the individual during the period the individual is serving on active

[403] Texas Tax Code § 171.101(a)(1)(B)(iii).

Back to Table of Contents

duty. It can only be deducted if the soldier is a Texas resident at the time the soldier is ordered to active duty.

The cost of training a replacement for the individual on active duty is also deductible in addition to the compensation or COGS deduction. The statute doesn't specify how to compute the "cost of training." The Comptroller has not offered much guidance regarding this deduction.

CC. Single Factor Apportionment

After determining margin, an entity apportions its taxable margin to Texas. Texas has a single-factor apportionment fraction determined using only gross receipts. An entity divides its gross receipts from business done in Texas over its entire gross receipts in order to determine what portion is taxable in Texas.

A business divides its Texas gross receipts by its total gross receipts in order to compute its apportionment fraction.

This is similar to the prior version of the franchise tax with one very important distinction: there is no throwback provision! Many taxpayers continue to erroneously apportion all gross receipts to Texas when they may not be required to do so.

The Comptroller's office has clarified that the apportionment provision in Tax Code Chapter 141, related to the Multistate Tax Compact (MTC), does not apply to the revised Texas franchise tax and entities may not elect to use the MTC's three-factor apportionment formula in lieu of the formula specified in Texas Tax Code Chapter 171.[404]

DD. Unitary Affiliates without Nexus

If a member of a combined group has no nexus with Texas, then the member doesn't include any of its Texas receipts in the numerator of the apportionment fraction.[405]

Regardless of whether a member of a combined group has nexus with Texas, the member includes all of its receipts (from Texas and everywhere else), in the denominator of the apportionment fraction.[406]

EE. Texas Gross Receipts

Taxpayers have historically determined Texas gross receipts by applying rules established over time by the Legislature, the courts and the Comptroller. State tax practitioners anticipate the sourcing rules under the margin computation will follow the guidance issued under the traditional franchise tax:

Sales of Property. This includes gross receipts from sales of tangible personal property and real property.

Tangible Personal Property. Receipts from sales of tangible personal property delivered to Texas purchasers are Texas receipts.[407] Sales of tangible personal property that will be apportioned to Texas include, but are not limited to:

404 Comptroller FAQs (added 01/26/11).
405 Texas Tax Code § 171.103(b).
406 Texas Tax Code § 171.105(c).
407 Tax Policy News, June 2010.

Back to Table of Contents

- Purchasers. The sale of tangible personal property that is delivered to a purchaser in Texas is a Texas gross receipt. Delivery is complete upon transfer of possession or control of the property to the purchaser, an employee of the purchaser, or transportation vehicles that the purchaser leases or owns. FOB point, location of title passage, and other conditions of the sale are not relevant to the determination of Texas gross receipts;
- Agents. The sale of tangible personal property that is delivered in Texas to an employee or transportation agent of an out-of-state purchaser is a Texas receipt. A carrier is an employee or agent of the purchaser if the carrier is under the supervision and control of the purchaser with respect to the manner in which goods are transported;
- Own Transportation. The sale and delivery in Texas of tangible personal property that is loaded into a barge, truck, airplane, vessel, tanker, or any other means of conveyance that the purchaser of the property leases and controls or owns is a Texas receipt.
- Common Carrier in Texas. The sale of tangible personal property that is delivered in Texas to an independent contract carrier, common carrier, or freight forwarder that a purchaser of the property hires results only in gross receipts everywhere if the carrier transports or forwards the property to the purchaser outside this state is a Texas receipt.
- Common Carrier Outside Texas. The sale of tangible personal property with delivery to a common carrier outside Texas, and shipment by that common carrier to a purchaser in Texas is a Texas Receipt.
- Pipeline Delivery. The sale of oil or gas to an interstate pipeline company, with delivery in Texas is a Texas receipt.
- Warehouse or Storage Facility. The sale of tangible personal property that is delivered in Texas to a warehouse or other storage facility that the purchaser owns or leases is a Texas receipt.
- Storage in Texas. The sale of tangible personal property that is delivered to and stored in a warehouse or other storage facility in Texas at the purchaser's request, as opposed to a necessary delay in transit is a Texas receipt, even though the property is subsequently shipped outside Texas.
- Drop Shipment. The drop shipment of tangible personal property in Texas. A drop shipment is a shipment of tangible personal property from a seller directly to a purchaser's customer, at the request of the purchaser, without passing through the hands of the purchaser. This results in Texas gross receipts for the seller and the purchaser.

Exchanges of property. Exchanges of property are included in gross receipts to the extent that the exchange is recognized as a taxable transaction for federal income tax purposes. Such exchange must be included in receipts based on the gross exchange value, unless otherwise required under this section.[408]

[408] Comptroller Rule 3.591(e)(9).

Back to Table of Contents

Leases and Subleases of Tangible Personal Property. Revenues from the lease or sublease (or rental or subrental) of tangible personal property are apportioned to the location where the property is used. If the property is used both inside and outside Texas, then lease payments are apportioned based on the number of days that the tangible personal property was used in Texas divided by the number of days that the tangible personal property was used everywhere.[409]

Real Property. Real property revenues are apportioned based upon the property's physical location. Gains from selling real estate located in Texas are Texas gross receipts. This includes revenues from the sale, lease, rental, sublease, or subrental of real property, including mineral interests.[410] Royalties from mineral interests are considered revenue from real property.

Inventory. Receipts from selling inventory are apportioned to the location where the buyer takes delivery of the item. Gross receipts from sales of items delivered in Texas are Texas gross receipts.[411]

- Delivered in Texas. Delivery is complete when the seller transfers possession and control of the product to the buyer, his employee, his agent, his vehicle or a vehicle the buyer supervises or controls.[412]

- Common Carrier Shipments. Delivery to a common carrier for shipment outside Texas is not a Texas receipt.

- Buyer's Warehouse in Texas. Receipts from sales of products delivered to a buyer's warehouse in Texas are Texas receipts, even if the buyer later ships them out-of-state.

Equipment and Fixed Asset Sales. Receipts are apportioned the same as inventory sales, except only the net gain is included in gross receipts. Capital assets and investments are also subject to a gain/loss netting rule.

Services. Services are apportioned based on the location where the service is performed. If a business performs a service both inside and outside of Texas, the receipts from those services are apportioned based on the fair value of services rendered in Texas.[413]

Example. Online Trading Activities. An investment company receives a fixed fee for accepting, executing and clearing trades initiated over the Internet. This is a receipt from the performance of a service. The services appear to involve work done inside and outside Texas. Therefore, Texas receipts should be determined based on the fair value of the services performed in Texas.

The Comptroller has stated that the fixed fees should be apportioned based upon the fair value of the services performed in Texas. A recent Comptroller letter suggested that the costs attributed to the services in Texas relative to the costs attributed to the out-of-state processing may be the best

409 Tax Policy News, September 2010.
410 Tax Policy News, September 2010.
411 Texas Tax Code § 171.103(a)(1).
412 Comptroller Rules 3.549(e)(41)(C) & 3.557(e)(41)(D).

413 Texas Tax Code § 171.103(a)(2).

Back to Table of Contents

means of determining the fair value of the services performed in Texas.[414]

Services Procurement. Revenues for the procurement of services are apportioned to the place where the service procurement is performed.

Transportation Services. For businesses in the transportation industry, only receipts from transportation services in *intrastate commerce* are apportioned to Texas. "Intrastate commerce" occurs when the entity transports passengers or freight from one point in Texas to another point in Texas if both pickup and delivery occur in Texas. Receipts from *interstate commerce*, where either pickup or delivery occurs outside of Texas, are not Texas receipts and no proration of these receipts is required for the portion of the transportation that occurred in Texas.[415]

Transportation companies have the option of apportioning receipts to Texas in one of two ways:

- Identifying the revenues derived from the transportation of goods or passengers in intrastate commerce within Texas; or
- Multiplying the total transportation receipts by a fraction with a numerator that is the total mileage in the transportation of goods and passengers that move in intrastate commerce within Texas and a denominator that is the total mileage everywhere.[416]

[414] *See* Comptroller Letter No. 200807139L (July 24, 2008). See *also* Hearing No. 46,585, and Hearing No. 35,481.
[415] Tax Policy News, September 2010.
[416] Tax Policy News, June 2010.

Subsidies or Grants. Proceeds of subsidies or grants that a taxable entity receives from a governmental agency are gross receipts, except when the funds are required to be expended dollar-for-dollar (i.e., passed through) to third parties on behalf of the agency. Receipts from a governmental subsidy or grant are apportioned in the same manner as the item to which the subsidy or grant was attributed.

Example. A taxable entity applies for and qualifies for a grant to conduct research for the government. The receipts from that grant are receipts from a service and are apportioned to the location where the research is performed.

Software Services. Gross receipts from sales of computer software <u>services</u> are apportioned to the location where the services are performed.[417]

Software Sales/Licenses. Receipts from sales or licenses of computer <u>programs</u> are treated for Texas franchise tax purposes as receipts from sales of intangible assets and are apportioned to the legal domicile of the payor.[418]

Internet Access Fee. A fee that is charged to obtain access to the "world wide web" in Texas is a Texas gross receipt.[419]

[417] Tax Policy News, June 2010.
[418] Tax Policy News, June 2010. Beware that the Comptroller considers a software license to be tangible personal property for sales and use tax purposes, and takes the position that licensing software to a customer in Texas could establish nexus for Texas sales and use tax purposes.
[419] Comptroller Rule 3.591(e)(12).

Rental & Lease Income. Texas receipts include receipts generated from the rental of property located in Texas.

- Revenues from the lease or sublease (or rental or subrental) of real property are apportioned to the location of the property.[420]

- Revenues from the lease or sublease (or rental or subrental) of tangible personal property are apportioned to the location of the property.[421]

- Mobile Property. If the property is used both inside and outside Texas, then lease payments are apportioned based on the number of days that the tangible personal property was used in Texas divided by the number of days that the tangible personal property was used everywhere. If the amount of revenue that is due under the lease is based on mileage, then the lease payments are apportioned based on the number of miles in Texas divided by the number of miles everywhere.[422]

- Revenues from the lease or sublease (or rental or subrental) of a vessel that engages in commerce are apportioned to Texas based on the number of days that the vessel is engaged in commerce in Texas waters divided by the number of days that the vessel is engaged in commerce everywhere.[423]

- Lump Sum Charge for Property in More Than One Location. If a lump sum is charged for leased or subleased (or rented or subrented) property that is located both inside and outside Texas, then the allocation of such revenue is based on the rental value of each item of property.[424]

- Lease Treated as a Sale. If a lease, sublease, rental, or subrental of real property or tangible personal property is treated as a sale for federal income tax purposes, then the receipts from the transaction are apportioned in the same manner as a sale. Any portion of the payments that the contracting parties designate as interest is interest receipts.[425]

Dividends & Interest. Taxpayers apportion dividend and interest income based on the location of payor rule.

The location of payor rule for dividends and interest has historically been one of the easiest ways to engage in margin tax planning.

Dividends and interest received from a corporation or other sources are apportioned to the legal domicile of the payor.[426] A corporation's legal domicile is its state of incorporation.[427] A limited liability company's legal domicile is also its state of incorporation.[428]

A partnership's or trust's legal domicile is the entity's principal place of business, which is where its day-to-day operations occur. If the day-to-day operations are conducted equally or fairly evenly in more than one state, then

420 Comptroller Rule 3.591(e)(13)(A).
421 Comptroller Rule 3.591(e)(13)(B).
422 Comptroller Rule 3.591(e)(13)(B).
423 Comptroller Rule 3.591(e)(13)(D).
424 Comptroller Rule 3.591(e)(13)(C).
425 Comptroller Rule 3.591(e)(13)(E).
426 Comptroller Rule 3.591(e)(8)(C).
427 Comptroller Rule 3.557(8).
428 Comptroller Rule 3.591(b)(7).

Back to Table of Contents

the principal place of business is its commercial domicile. The commercial domicile is the principal place from where an entity's trade or business is directed.

Dividends and interest received from a national bank are apportioned to Texas if the bank's principal place of business is located in Texas. Dividends and interest received from a bank that is organized under the Texas Banking Code are also apportioned to Texas.[429] Dividends and interest from out-of-state banks or banks with a principal place of business outside Texas are apportioned out of state.[430]

Dividends that are recognized as a reduction of the taxpayer's basis in stock of a taxable entity for federal income tax purposes are not gross receipts. Dividends that exceed the taxpayer's basis for federal income tax purposes that are recognized as a capital gain are treated as dividends for apportionment purposes.[431]

The following types of dividends and interest are excluded from both the numerator and the denominator of the apportionment formula:[432]

- dividends from a subsidiary, associate, or affiliated taxable entity that does not transact a substantial portion of its business or regularly maintain a substantial portion of its assets in the United States;

- schedule C special deductions that are excluded from total revenue;

- dividends and/or interest on federal obligations that are excluded from total revenue; and

- interest that is exempt from federal income tax.[433]

Exclusion of Certain Interest from Apportionment Factor. The Texas Tax Code apportions margin tax based upon the ratio of Texas gross receipts to total gross receipts. In general, the Texas Tax Code apportions bank dividends and interest according to the "location of payor" rule.

The law provides exclusions for federal interest and for certain interest received from a correspondent bank located in Texas. A correspondent bank relationship exists where a bank has exposure another insured depository institution but the two entities are not commonly controlled.[434]

Banking corporations exclude from the numerator of the bank's apportionment factor any interest earned on federal funds and securities sold under certain repurchase agreements with correspondent banks. The repurchase agreement must be for funds held in Texas in a correspondent bank that is domiciled in this state.[435] For purposes of apportionment, bank holding companies are not treated as banking corporations.

429 Tax Policy News, June 2010.
430 Tax Policy News, June 2010.
431 Comptroller Rule 3.591(e)(8)(A).
432 Comptroller Rule 3.591(e)(8)(B).
433 Comptroller Rule 3.591(e)(8)(B).
434 *See* 12 C.F.R. § 206.2.
435 Texas Tax Code § 171.106(d). "Correspondent" has the meaning assigned by 12 C.F.R. § 206.2(c).

Back to Table of Contents

Investments & Capital Assets. For franchise tax apportionment purposes, a capital asset is defined as "[a]ny asset, other than an investment, that is held for use in the production of income, and that is subject to depreciation, depletion or amortization."[436] An investment is any non-cash asset that is not a capital asset.[437]

Sourcing receipts from sales of investments and capital assets is a two step process. First, the receipts are sourced based on the applicable rules for the underlying asset. The amount of the receipts is limited to the gain arising from the sale. Second, the cumulative gains & losses are netted in order to determine the amount to be apportioned.

- Net gains and losses from sales of investments and capital assets are added together to determine the total gross receipts from such transactions.
- If both Texas and out-of-state sales have occurred, the taxable entity makes a separate calculation of net gains and losses on Texas sales.
- If the combination of net gains and losses results in a net loss, the taxable entity should net the loss against other receipts, but not below zero.
- In no instance shall the apportionment factor be greater than 1.

A taxpayer should apportion net gains on sales of intangibles held as capital assets or investments to the location of the payor. Examples of intangibles include, but are not limited to, stocks, bonds, commodities, futures contracts, patents, copyrights, licenses, trademarks, franchises, goodwill, and general receivable rights.

Intangibles. Receipts from sales or licenses of intangibles are apportioned according to the type of intangible asset and where it is used:

- Sales of intangibles are apportioned based on the location of payor.
- Revenues from a patent royalty are included in Texas receipts to the extent that the patent is utilized in production, fabrication, manufacturing, or other processing in Texas.
- Revenues from a copyright royalty are included in Texas receipts to the extent that the copyright is utilized in printing or other publication in Texas.
- Revenues that the owner of a trademark, franchise, or license receives are included as Texas receipts to the extent the trademark, franchise or license is used in Texas.
- Royalties from an affiliated taxable entity that does not transact a substantial portion of its business or regularly maintain a substantial portion of its assets in the United States are excluded from Texas receipts and receipts everywhere.

In general, net gains or losses on sales of intangibles held as capital assets or investments are apportioned to the location of the payor. Examples include: stocks, bonds, commodities, futures contracts, patents, copyrights, licenses, trademarks, franchises, goodwill and general receivable rights.[438]

[436] Comptroller Rule. 3.591(b)(1).

[437] Comptroller Rule 3.591(b)(6).

[438] Tax Policy News, June 2010.

Back to Table of Contents

Loans and Securities. Receipts from servicing loans secured by real property located in Texas are Texas gross receipts. Receipts from sales of loans and securities are apportioned based on the location of the payor. If securities are sold through an exchange, and the buyer cannot be identified, then the Comptroller's policy is to treat 7.9 percent of the revenue as a Texas receipt.[439]

The Texas margin tax defines "securities" with reference to the federal tax rules.[440] Securities include:

- shares of stock in a corporation
- partnership or beneficial ownership interests in a widely held or publicly traded partnerships or trusts
- notes, bonds, debentures, or other evidence of indebtedness
- interest rate, currency, or equity notional principal contracts
- evidence of an interest in, or a derivative financial instrument in, any security described above, or any currency, including any option, forward contract, short position, and any similar financial instrument in such a security or currency; and
- positions which are not securities described above but are hedges with respect to such securities and are clearly identified in the dealer's records on the day the investment is made
- notional principal contracts with respect to any commodity which is actively traded
- evidence of an interest in, or a derivative instrument in, any notional principal contract or actively traded commodity, including any option, forward contract, futures contract, short position, and any similar instrument in such a commodity
- positions which are not commodities described above but are hedges with respect to commodities and are clearly identified in the dealer's records on the day the investment is made

Taxpayers that treat loans or securities as inventory of the seller for federal income tax purposes should include the gross proceeds of the sale of those loans or securities in gross receipts.[441]

In 2009, the legislature revised the Tax Code to reference FAS 115 in determining whether gross proceeds from sales of loans or securities are considered gross receipts for lending institutions. This change effectively clarifies that lending institutions with "securities available for sale" and "trading securities" use the gross proceeds for apportionment purposes.

Flow-Through Income. The rules for sourcing flow-through net income from passive entities remain the same under the margin computation as they were under the former franchise tax. An entity's share of a partnership's or joint venture's gross receipts are apportioned as though the taxable entity directly earned the receipts.

Loan Servicing. Receipts derived from serving loans secured by real

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[439] Tax Policy News, September 2010.

[440] *See* Texas Tax Code § 171.0001 (13-a), referencing IRC § 475(c)(2).

[441] Texas Tax Code § 171.106(f) (added by H.B. 3928).

Back to Table of Contents

property in Texas are apportioned to Texas.[442]

Condemnation. Revenues from condemnation that result from the taking of property are gross receipts that are apportioned based on the location of the property condemned.[443]

Debt Forgiveness. If a creditor releases any part of a debt, then the amount that the creditor forgives is a gross receipt that is apportioned to the legal domicile of the creditor.[444]

Debt Retirement. Revenues from the retirement of a taxable entity's own indebtedness, such as through the taxable entity's purchase of its own bonds at a discount, are gross receipts that are apportioned to the taxable entity's legal domicile. The Comptroller treats the indebtedness as an investment in the determination of the amount of gross receipts.[445]

Deemed Asset Sales. Deemed sales of assets under Internal Revenue Code, §338 are treated as asset sales for Texas franchise tax apportionment purposes. Amounts that are deemed to have been received by the target taxable entity are treated as sales of assets by the target taxable entity, and are apportioned according to rules that otherwise apply to sales of such assets. The Comptroller considers the purchaser of the target's stock under these rules to be the purchaser of the assets.[446]

[442] Texas Tax Code § 171.103(a)(2).
[443] Comptroller Rule 3.591(e)(4).
[444] Comptroller Rule 3.591(e)(5).
[445] Comptroller Rule 3.591(e)(6).
[446] Comptroller Rule 3.591(e)(7). *See also* Comptroller Letter No. 200806202L (June 1, 2008).

Flow-Through Income. The rules for sourcing flow-through net income from passive entities remain the same under the margin computation as they were under the former franchise tax. An entity's share of a partnership's or joint venture's gross receipts are apportioned as though the taxable entity directly earned the receipts.

Passive Entities. The net distributive income from a passive entity that is included in total revenue is apportioned to the principal place of business of the passive entity.[447]

Insurance Proceeds. The apportionment rules for insurance proceeds depend upon the type of insurance and the type of item insured.

Business interruption insurance proceeds are gross receipts when the proceeds are intended to replace lost profits. Therefore, such receipts are apportioned to the legal domicile of the payor of the proceeds.[448]

Revenues from fire and casualty insurance proceeds are designed to replace the value of physical property. Therefore, they are apportioned to the location of the damaged or destroyed property.[449]

Litigation Awards. Revenues that are realized from litigation awards are generally gross receipts that are apportioned to the legal domicile of the payor of the proceeds. However, if the litigation awards are intended to replace receipts for which another apportionment rule is provided, then the

[447] Comptroller Rule 3.591(e)(19).
[448] Comptroller Rule 3.591(e)(11)(A).
[449] Comptroller Rule 3.591(e)(11)(B).

apportionment must be made in accordance with that rule.

Example. A taxable entity sues a Delaware corporation to recover on a sale of goods delivered to a Texas location and receives a judgment for the amount of the sale. The receipts are Texas receipts. The fact that they are received as a litigation award would not convert the receipts from Texas receipts to Delaware receipts.

Special Rules for Gas Producers. Revenues that a gas producer realizes from litigation awards for a breach of contract, reimbursements for litigation-related expenses (e.g., documented attorney's fees or court costs), or interest (upon which the parties have agreed, that the records of the producer reflects, or in an amount that a court has ordered) are gross receipts and are apportioned to the legal domicile of the payor.[450]

Revenues that a gas producer realizes from a judgment, compromise, or settlement relating to the recovery of a contract price of gas produced are gross receipts and are apportioned to Texas to the extent the contract specified delivery to a location in Texas. Revenues that a gas producer realizes from a judgment, compromise, or settlement that relates to several claims or causes of action shall be prorated based upon the documented amounts due under the contract for each claim or cause of action according to the records of the producer.

Example. A settlement sum of $100,000 for a pricing dispute of $25,000 and for failure to pay for gas not taken in the amount of $225,000, would result in receipts of $10,000 from gas sales (100,000 X 25,000/250,000) and receipts from other business of $90,000 (100,000 X 225,000/250,000).

Records of the producer shall include, but are not limited to the following: contracts, settlement agreements, accounting records and entries, court pleadings and worksheets, including calculations reflecting settlement amounts.[451]

Advertising. The apportionment of receipts from advertising are based upon the type of media in which the advertising appears.

Magazines or Newspapers. The Comptroller's rules apportion to Texas all advertising revenues of a newspaper or magazine based on the number of newspapers or magazines distributed in Texas. This includes those revenues derived from out-of-state advertisements.

Radio or Television. All advertising revenues of a radio or television station that broadcasts or transmits from a location in Texas constitute Texas receipts, even though some of the listening or viewing audiences are located outside Texas.

Phone Calls. The apportionment of gross receipts from telephone calls depends upon where the call originates and terminates:

- Revenues from telephone calls that both originate and terminate in Texas are Texas receipts.
- Revenues from telephone calls that originate in Texas but terminate

450 Comptroller Rule 3.591(f)(5).

451 Comptroller Rule 3.591(f)(6).

outside of Texas or that originate outside of Texas but terminate in Texas are excluded from Texas receipts.

- Revenues from other telecommunication services are Texas receipts if the services are performed in Texas.

Membership & Enrollment Fees. Membership or enrollment fees paid for access to benefits should be considered gross receipts from the sale of an intangible asset and are apportioned to the legal domicile of the payor.[452]

Natural Gas Production. Revenues from natural gas production are apportioned based upon the terms of the contract.

- Revenues that a gas producer realizes from the contract price of gas that the gas producer produces and that the purchaser takes pursuant to the terms of sales are gross receipts and are apportioned to Texas, if the gas is delivered in Texas.
- Revenues that a gas producer realizes from a purchaser's payment under a sale or purchase contract for gas to be produced even if no gas is produced and delivered to the purchaser, are gross receipts and are apportioned to the legal domicile of the payor.
- Revenues that a gas producer realizes from a purchaser's payments to terminate a gas purchase contract are gross receipts and are apportioned to the legal domicile of the payor.
- Revenues that a gas producer realizes from a contract amendment that relates to the price of the gas sold are gross receipts from the sales of gas and are apportioned to Texas if delivery is made to a location in Texas. Revenues that the gas producer realizes from a contract amendment that relates to a provision other than the price of gas sold are gross receipts and are apportioned to the legal domicile of the payor.

Mixed Transactions. If a transaction involves elements of both a sale of tangible personal property and a service, but no documentation exists to show separate charges for the sale and service elements, then the Comptroller may determine the amounts that are allocable to each element based on fair values or on any available evidence.[453]

Sales Taxes. State or local sales taxes that are imposed on the customer, but are collected by a seller are not gross receipts of the seller. However, discounts that a seller is allowed to take in remittance of the collected sales tax are gross receipts to the seller.

Bad Debt Recoveries. Bad debt recoveries are gross receipts. The apportionment is based upon the nature of the original transaction. If the original transaction would have been apportionable to Texas, the recovery of the related bad debt is apportionable to Texas.

Exclusion of Certain Interest from Apportionment Factor. The Texas Tax Code apportions margin tax based upon the ratio of Texas gross receipts to total

452 Comptroller Rule 3.591(f)(17).

453 Comptroller Rule 3.591(f)(18).

gross receipts. In general, the Texas Tax Code apportions bank dividends and interest according to the "location of payor" rule.

The law provides exclusions for federal interest and for certain interest received from a correspondent bank located in Texas. A correspondent bank relationship exists where a bank has exposure another insured depository institution but the two entities are not commonly controlled.[454]

Banking corporations exclude from the numerator of the bank's apportionment factor any interest earned on federal funds and securities sold under certain repurchase agreements with correspondent banks. The repurchase agreement must be for funds held in Texas in a correspondent bank that is domiciled in this state.[455] For purposes of apportionment, bank holding companies are not treated as banking corporations.

Administrative Services to Regulated Investment Companies.

The franchise tax statute provides a special apportionment formula applicable to regulated investment companies.

A regulated investment company does not have to pay federal income taxes on distributions of dividends, interest, and realized capital gains, as long as it complies with federal standards and requirements.[456] In order to qualify as a regulated investment company a firm must derive at least 90% of its income from dividends, interest, and capital gains. It also must distribute at least 90% of the dividends and interest received and maintain a minimum diversification of its assets.

A taxable entity's margin that is derived, directly or indirectly, from the sale of management, distribution, or administration services to or on behalf of a regulated investment company is apportioned to Texas based upon the ratio of the average sum of shares owned at the beginning and end of the year by investment company shareholders in Texas and everywhere.

Business entities are located in Texas if they are commercially domiciled here. Individual shareholders are located in Texas if they are Texas residents.

These rules also apply for taxable entities that are trustees or sponsors of employee benefit plans that have accounts in a regulated investment company.

Investment Services to Employee Retirement Plans.

The franchise tax statute also provides a special apportionment formula applicable to employee retirement plans.

For margin tax purposes, an "employee retirement plan" is a plan or other arrangement that is qualified under IRC § 401(a) or satisfies IRC § 403, or a government plan described in IRC §

[454] *See* 12 C.F.R. § 206.2.
[455] Texas Tax Code § 171.106(d). "Correspondent" has the meaning assigned by 12 C.F.R. § 206.2(c).

[456] "Regulated investment company" has the meaning assigned by IRC § 851(a).

Back to Table of Contents

414(d). The term does not include an individual retirement account or individual retirement annuity within the meaning of IRC § 408.

A taxable entity's margin that is derived, directly or indirectly, from the sale of management, administration, or investment services to an employee retirement plan is apportioned to Texas by multiplying the taxable entity's total margin from the sale of services to an employee retirement plan company by a fraction.

The numerator of the fraction is the average of the sum of beneficiaries domiciled in Texas at the beginning of the year and the sum of beneficiaries domiciled in Texas at the end of the year. The denominator is the average of the sum of all beneficiaries at the beginning of the year and the sum of all beneficiaries at the end of the year.[457]

Texas waters. Revenues from transactions that occur in Texas waters are Texas receipts. Texas waters are considered to extend to 10.359 statute miles, or nine nautical miles, from the Texas coastline.

Federal Enclave. All revenues from a taxable entity's sales, services, leases, or other business activities that are transacted on a federal enclave that is located in Texas are Texas receipts, unless otherwise excepted by this section.

Defense Readjustment Zones. Receipts from services that a defense readjustment project performs in a defense economic readjustment zone are not receipts from business done in this state.

[457] Comptroller Rule 3.591(c)(2).

Multistate Tax Compact. In the July 2010 Tax Policy News, the Comptroller cautions that "[t]he apportionment provision in Texas Tax Code Chapter 141, related to the Multistate Tax Compact (MTC), does not apply to the revised Texas franchise tax and entities may not elect to use the MTC's three-factor apportionment formula in lieu of the formula specified in Texas Tax Code Chapter 171."[458]

2011 Update. In *TGS-NOPEC Geophysical Co. v. Combs,*[459] the Texas Supreme Court recently held that a taxpayer's receipts from licensing seismic data were receipts from a sale of an intangible asset and therefore should be apportioned based upon the location of the payor.

Receipts from services are apportioned to the location where the service is performed. If services are performed both inside and outside Texas, they are apportioned to on the basis of the fair value of the services performed in Texas.[460]

Receipts from sales or leases of tangible personal property delivered to Texas purchasers are Texas receipts.[461] Revenues from the lease or sublease (or rental or subrental) of real property are apportioned to the location of the property.[462]

The apportionment of intangibles depends on the type of intangible. Net gains or losses on sales of intangibles

[458] Tax Policy News, July 2010.
[459] 340 S.W.3d 432, 54 Tex. Sup. Ct. J. 1023 (Tex. 2011).
[460] Tax Policy News, September 2010.
[461] Tax Policy News, June 2010.
[462] Tax Policy News, September 2010.

Back to Table of Contents

held as capital assets or investments are apportioned to the location of the payor. Examples include: stocks, bonds, commodities, futures contracts, patents, copyrights, licenses, trademarks, franchises, goodwill and general receivable rights.[463]

TGS required its customers to enter into nonexclusive master license agreements describing TGS's seismic data as proprietary. For many years, the Comptroller had characterized the licenses as intangibles and apportioned the revenues based upon the location of the payor's domicile. In 2004, the Comptroller audited TGS and recharacterized the revenue as apportionable to Texas as receipts from licenses used here. The Court determined the Comptroller's characterization conflicted with her rule, which allocates receipts from software licenses based upon the location of the payor. Since the license was used to transfer the underlying intangible, the Court determined TGS had appropriately apportioned the gross receipts based upon the location of payor and was entitled to recover its payment of tax, penalties and interest.

FF. Combined Reporting

Combined groups must file a combined margin tax report.[464] A combined group consists of otherwise taxable entities that comprise an affiliated group that engages in a unitary business.[465]

An affiliated group is a group of one or more entities in which a controlling interest is owned by a common owner or owners, or by one or more member entities.[466] "Controlling interest" means **more than 50%** direct or indirect ownership of the voting power or beneficial ownership interest in an entity.[467]

The following examples are from the Comptroller's rules:

Example 1.

Corporation A owns 10% of Corporation C and 60% of Corporation B. Corporation B owns 41% of Corporation C.

Corporation A has a controlling interest in Corporation B and a controlling interest in Corporation C of 51% of stock ownership because it has control of the stock owned by Corporation B.[468]

Since Corporation A owns more than 50% of Corporation B, Corporation B's entire 41% interest in Corporation C is attributed to Corporation A. The 41% indirect interest, plus the 10% direct interest gives Corporation A the 51% interest.

Example 2.

Corporation A owns 10% of Limited Liability Company C and 15% of Corporation B. Corporation B owns 90% of Limited Liability Company C.

Corporation A does not have controlling interest in Limited Liability Company C and does not have a

[463] Tax Policy News, June 2010.
[464] Texas Tax Code § 171.1014(a).
[465] Texas Tax Code § 171.0001(7).
[466] Texas Tax Code § 171.0001(1).
[467] Texas Tax Code § 171.0001(8).
[468] Comptroller Rule 3.590 (b)(4)(B)(i).

controlling interest in Corporation B. Corporation B has a controlling interest in Limited Liability Company C.[469]

Example 3.

Individual A owns 100% of 10 corporations, each of which owns 10% of Partnership B. Individual A has a controlling interest in each of the ten corporations (directly) and in Partnership B (indirectly).[470]

Example 4.

Corporation A holds a 70% interest in Partnership B. Partnership B owns 60% of Limited Liability Company C. Corporation A owns the remaining 40% of Limited Liability Company C.

Corporation A owns a controlling interest (70%) in Partnership B. Taking into account Company A's direct (40%) and indirect (60%) ownership of Limited Liability Company C, Company A owns a 100% controlling interest in Limited Liability Company C.[471]

Example 5.

Corporation A owns 10% of Limited Liability Company C and 45% of Corporation B. Corporation B owns 90% of Limited Liability Company C.

Corporation A's would 10% interest in Limited Liability Company C does not constitute a controlling interest. However, Corporation B has a controlling interest in Limited Liability Company C.[472]

469 Comptroller Rule 3.590 (b)(4)(B)(ii).
470 Comptroller Rule 3.590 (b)(4)(B)(iii).
471 Comptroller Rule 3.590 (b)(4)(B)(iv).
472 Comptroller Rule 3.590 (b)(4)(B)(v).

Corporation B and Limited Liability Company C are affiliated. Corporation A is not affiliated with Corporation B or Limited Liability Company C.

Example 6.

Partnership P is owned equally (1/3 or 33.3% each) by Limited Liability Company A, Limited Liability Company B and Limited Liability Company C.

Limited Liability Company A, Limited Liability Company B and Limited Liability Company C are each wholly owned by three unrelated individuals.

None of the limited liability companies owns more than 50% of Partnership P. Therefore, there is no controlling interest.[473]

Variation 6A.

The owners of Limited Liability Company A and Limited Liability Company B are husband and wife.

An individual constructively owns stock or interest that is owned by his or her spouse.[474] Therefore, the spouses' ownership interests in Limited Liability Company A and Limited Liability Company B constitute a combined 2/3 (66.6%) ownership in Partnership P. Therefore, Limited Liability Company A and Limited Liability Company B are affiliated with each other and Partnership P. Limited Liability Company C remains unaffiliated and therefore must file a separate return.

473 Comptroller Rule 3.590 (b)(4)(B)(vi).
474 Comptroller's FAQ No. 9 Combined Reporting. Available online at: http://www.cpa.state.tx.us/taxinfo/franchise/faq_comb_rpt.html#comb_rpt1.

Variation 6B.

The owners of Limited Liability Company A and Limited Liability Company B are brothers. The entities still are not affiliated. Other than spousal attribution, there is no other attribution of ownership between family members.[475]

Example 7.

Individual A and Individual B each own 50% of Partnership X. Individual A and Individual B also each own 50% of Partnership Y.

Individual A and Individual B are not husband and wife. Since neither individual owns more than 50% of each partnership, neither individual has a controlling interest in the partnerships.[476]

A **unitary business** is:

> A **single economic enterprise** made up of **separate parts** of a single entity or of a commonly controlled group of entities significantly **interdependent, integrated,** and **interrelated** through their activities to provide a **synergy** and **mutual benefit** that produces a **sharing** or **exchange of value** among them and a significant **flow of value** to the separate parts.[477]

As a general rule, a state "may not tax 'nonunitary' income received by a

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[475] Comptroller's FAQ No. 9 Combined Reporting. Available online at: http://www.cpa.state.tx.us/taxinfo/franchise/faq_comb_rpt.html#comb_rpt1.
[476] Comptroller Rule 3.590 (b)(4)(B)(vii).
[477] Texas Tax Code § 171.0001(17).

Back to Table of Contents

nondomaciliary corporation from an 'unrelated business activity.'"[478] In the case of *Hunt-Wesson v. the Franchise Tax Board of California*,[479] the U.S. Supreme Court determined that California wrongfully disallowed interest expense to a multistate corporation to the extent the amount exceeded certain out-of-state income arising from the unrelated business activity of a discrete business enterprise.

The unitary business principle is said to do a "better job of accounting for 'the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise' than, for example, geographical or transactional accounting."[480]

In Texas, the Legislature has directed the Comptroller to consider "any relevant factor" when determining if an affiliated group is unitary.[481] The Legislature provided three specific areas for the Comptroller to consider:

Same Line of Business. The statute lists examples of "lines of business." They include manufacturing, wholesaling, retailing of tangible personal property, insurance, transportation, or finance.[482]

The case of *Container Corporation v. Franchise Tax Board*,[483] considered whether California could impose tax on its apportioned share of in-state and out-of-state entities engaged in the business of manufacturing custom-ordered paperboard from raw timber and wastepaper.[484] The Court focused on whether there was some "sharing or exchange of value not capable of precise identification or measurement – beyond the mere flow of funds arising out of a passive investment or a distinct business operation – which renders formula apportionment a reasonable method of taxation.[485]

The Court determined the relationship between the taxpayer and its subsidiaries was "decidedly close," supporting the imposition of the apportioned tax on the unitary business.[486] Specifically, the court noted that the taxpayer provided for or guaranteed approximately half of the subsidiaries' long-term debt, assisted the subsidiaries in procuring equipment, and performed a variety of other activities on behalf of or providing assistance to the subsidiaries.[487] These activities exemplified the flows of value that apportioned unitary taxation was designed to address.

Vertical Integration. The statute lists examples of vertically-structured enterprises or businesses. These businesses are involved in various steps or stages of an integrated process, such as the production of natural resources—exploration, mining, refining, and marketing.[488]

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478 Hunt-Wesson v. Franchise Tax Bd. of Cal, 528 U.S. 458 (2000).
479 Hunt-Wesson v. Franchise Tax Bd. of Cal, 528 U.S. 458 (2000).
480 Allied-Signal, Inc. v. New Jersey, 504 U.S. 768, 783 (1992).
481 *Id.*
482 Texas Tax Code § 171.0001(17)(A)(i).
483 463 U.S. 159 (1983).
484 *Id.* at 172.
485 *Id.* at 166.
486 *Id.* at 173.
487 *Id.*
488 Texas Tax Code § 171.0001(17)(A)(ii).

The case of *Mobil Oil Corp. v. Vermont*,[489] considered whether the State of Vermont could impose tax on an apportioned share of Mobil Oil's "foreign source" dividend income.[490] Mobil Oil engaged in an integrated petroleum business.

Its business activities ranged from exploring for petroleum reserves to production, refining, transportation, distribution and sale of petroleum and petroleum products, and chemical and mining activities.[491] Mobil Oil conducted these activities in more than 40 states, the District of Columbia, and several foreign countries.[492] Mobil Oil had no oil or gas production or refineries in Vermont. Its activities there were limited to wholesale and retail marketing of petroleum and petroleum products.[493]

The Court considered whether Vermont could impose its annual net income tax on an apportioned share of Mobil Oil's worldwide income.[494] The tax was apportioned based on a three-factor formula, which considered property, payroll and sales from business conducted in Vermont versus business conducted everywhere.[495]

The case focused on certain income that Mobil Oil had treated as "nonapportionable." This included net dividends from domestic corporations formed in states other than Vermont and from corporations organized and operating abroad. Mobil Oil had excluded those amounts from its net income before apportionment and challenged Vermont's assessment on the income.

The Court determined the dividends were apportionable because they were derived from interstate activities that formed part of a single unitary business.[496] The Court referenced that the activities arise from the operation of the business as a whole and therefore had a unitary connection to Mobil Oil's vertically integrated business.[497]

Similarly, in *Exxon Corp. v. Wisconsin Dept. of Revenue*,[498] the Supreme Court considered whether Wisconsin could impose tax on the worldwide business of Exxon, which included exploration, production, refining and marketing of petroleum and related products. As with the *Mobil Oil* case, Exxon confined its activities within Wisconsin to marketing its product through sales at service stations.[499] Some of the service stations sold Exxon products; others sold competitors' products. When the service stations purchased from Exxon, they did so using standard industry price lists.

In reviewing the *Exxon* case, the Court determined the various divisions of Exxon were all part of a single unitary business. In order to exclude income, the company must prove the income was earned in activities unrelated to sales of petroleum.[500] The Court held Exxon did not meet that burden of proof.

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489 445 U.S. 425 (1980).
490 *Id.* at 427.
491 *Id.* at 428.
492 *Id.*
493 *Id.*
494 *Id.*
495 *Id.*
496 *Mobil Oil*, 445 U.S. *at* 439.
497 *Id.*
498 447 U.S. 207 (1980).
499 *Id.*
500 *Id.*

Back to Table of Contents

Functional Integration. Whether the group members have strong centralized management. The statute lists examples of "strong centralized management," including authority over purchasing, financing, product line, personnel, and marketing.[501]

The case of *ASARCO, Inc. v. Idaho State Tax Comm'n.*,[502] determined that Idaho could not constitutionally tax dividend, interest and capital gains income generated by nonunitary business activities abroad.[503]

The Court focused on whether ASARCO could assert operational control over the businesses that generated the alleged nonunitary income.[504] For example, ASARCO owned 51.5% of the stock of Southern Peru, but the other owners of Southern Peru had refused to participate if the ownership interest would cause ASARCO to have complete operation control.[505]

The Court stated that "[w]here the business activities of the dividend payor have *nothing to do* with the activities of the recipient in the taxing State, *due process considerations might well preclude apportionability, because there would be no underlying unitary business.*"[506] In ASARCO's case, the Court reviewed the underlying business that generated the income and determined it was *not* unitary with ASARCO's business.

501 Texas Tax Code § 171.0001(17)(B).
502 458 U.S. 307 (1982).
503 *Id.* at 320.
504 *Id.*
505 *Id.* at 321.
506 *Id.* at 317-318.

Similarly, in *F.W. Woolworth Co. v. New Mexico*,[507] the Supreme Court determined that New Mexico could not impose its tax on subsidiaries that were not part of a unitary business with Woolworth's operations in New Mexico. The subsidiaries were foreign entities that did no business in New Mexico.

Woolworth's principal place of business and commercial were in New York. Woolworth owned retail business locations, which sold dry goods, hardware, small appliances, confections, packaged goods, fountain items, and other goods throughout the United States, Puerto Rico and the Virgin Islands. The lawsuit focused on four foreign subsidiaries operating in Canada, Mexico, England and Germany.[508]

The Court determined the businesses were not unitary because there was very little functional integration.[509] While each subsidiary engaged exclusively in the business of retailing (i.e. the "same line of business"), the operations lacked functional integration because each subsidiary had a separate accounting department, financial staff, and outside counsel. Each subsidiary was responsible for obtaining its own financing from sources other than the parent. There was no centralized purchasing, manufacturing or warehousing of merchandise. In other words, each subsidiary was autonomous and independent.[510]

The Supreme Court determined these facts did not support the flow of value necessary to constitute a unitary business

507 458 U.S. 354 (1982).
508 *Id.* at 357.
509 *Id.* at 365.
510 *Id.* at 366-367.

and denied New Mexico's efforts to impose tax on the nonunitary business.[511]

Courts consider the following types of factors in determining whether a particular business is unitary. Therefore it's likely the Comptroller will consider these and other factors in determining whether a particular business is unitary and therefore required to file a combined report:

- Inter-company loans or transfers of funds between parent companies and subsidiaries.[512]
- Parent guarantees of subsidiaries' long-term debt obligations[513]
- Advice and consultation[514]
- Manufacturing techniques
- Shared engineering
- Common designs
- Unified architectural plans
- Combined insurance
- Cost accounting[515]
- Technical service agreements
- Coordinated employee training programs[516]
- Transfers of personnel from one commonly owned entity to another[517]
- Establishment of standards of professionalism, profitability and ethical practices.[518]
- Board approvals by the parent corporation of the subsidiaries' activities.
- Parent corporation dealing with major problems and long-term decisions of the subsidiaries' business.[519]
- Coordinated decisions regarding capital investments.[520]
- Coordinated procurement services (establishing a centralized purchasing department or using the parent's purchasing department to place orders on the subsidiaries' behalf)
- Shared equipment. Does one entity own the equipment and lease it to the others?
- One entity's assistance in sale of equipment by another entity.[521]
- Commingled general operating accounts.[522]
- Oversight of site selection for retail outlets.[523]
- Centralized purchasing, warehousing, or manufacturing.[524]
- Intercompany sales of inventory.[525]
- Intercompany transfers of raw materials.[526]
- Rotation of personnel.[527]

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511 *Id.* at 371.
512 *See* Allied-Signal, Inc. v. New Jersey, 504 U.S. 768, 782 (1992).
513 *See, e.g.*, Container Corp. v. California, 463 U.S. 159, 171 (1983).
514 *See* Allied-Signal, Inc. v. New Jersey, 504 U.S. 768, 782 (1992).
515 *See* Allied-Signal, Inc. v. New Jersey, 504 U.S. 768, 782 (1992).
516 *See, e.g.*, Container Corp. v. California, 463 U.S. 159, 171 (1983).
517 *See id.*
518 *See id.*
519 *See id.*
520 *See, e.g.*, Container Corp. v. California, 463 U.S. 159, 171 (1983).
521 *See id.*
522 *See, e.g.*, F.W. Woolworth Co. v. New Mexico, 458 U.S. 354 (1982).
523 *See, e.g.*, F.W. Woolworth Co. v. New Mexico, 458 U.S. 354 (1982).
524 *See id.*
525 *See id.*
526 *See, e.g.*, Exxon Corp. v. Wisconsin, 447 U.S. 207, 212-213 (1980).
527 *See id.*

Back to Table of Contents

- Frequent coordinated meetings.[528]
- Uniform credit card systems.[529]
- Uniform packaging.[530]
- Uniform brand names.[531]
- Uniform displays.[532]
- Coordinated legal departments.[533]

Easy sources of information for Comptroller auditors to review include:

- The business's website. Is it coordinated with other entities? Do they have links to each others' sites? Do they have an integrated website? What statements are made on the website?
- SEC reporting. Is it integrated? What statements are made regarding benefits of common ownership?
- Lawsuit filings. Do the entities engage in a joint defense or prosecution of intellectual property claims?
- IP filings. Do the entities share common ownership or licensing to intellectual property? Do some of the entities use intellectual property owned by other entities?

The case of *MeadWestvaco Corp. v. Illinois Dept. of Revenue*, 553 U.S. 16 (2008), affirmed that the three factors for ascertaining whether there should be a unitary business, particularly when the asset of a business is another business, are functional integration, centralized management and economies of scale. The Supreme Court clarified that its language regarding "operational purpose" should not be interpreted as an additional ground for apportionment.

The case in chief considered whether Illinois could constitutionally tax an apportioned share of the capital gain arising from an out-of-state corporation's sale of one of its business divisions. Mead, an Ohio corporation formed in 1864, was in the business of producing and selling paper, packaging and school and office supplies. Mead also owned an electronic research service, Lexis, which it had purchased in 1968 and sold in 1994. Mead did not report any of the gain from the sale on its Illinois business tax returns because it considered the proceeds to be nonbusiness income unrelated to the unitary business of Mead. The Illinois Department of Revenue audited Mead and assessed tax on the income from the sale of the electronic research service.

The Supreme Court evaluated whether Lexis was part of Mead's unitary business. Lexis had been a wholly owned subsidiary until 1980, when it merged into Mead. Lexis was subject to Mead's general oversight but a separate management team in Illinois directed its day to day business activities. Lexis and Mead maintained separate manufacturing, sales, and distribution facilities, as well as separate accounting, legal, human resources, credit and collections, purchasing, and marketing departments. Neither business was required to purchase goods or services from the other, nor did they receive discounts on purchases. In fact,

528 *See, e.g.*, F.W. Woolworth Co. v. New Mexico, 458 U.S. 354 (1982).
529 *See id.*
530 *See id.*
531 *See id.*
532 *See id.*
533 *See, e.g.*, F.W. Woolworth Co. v. New Mexico, 458 U.S. 354 (1982).

Lexis purchased most of its paper from other suppliers, and neither entity was a significant customer of the other. Mead generally limited its involvement to approving Lexis' annual business plan and reviewing any significant corporate transactions (such as capital expenditures, financings, mergers and acquisitions, or joint ventures).

The trial court reasoned that Lexis and Mead could not be unitary because they were not functionally integrated or centrally managed and enjoyed no economies of scale; nonetheless, the trial court required apportionment of the sale proceeds to Illinois because Lexis served an "operational purpose" in Mead's business, particularly in the allocation of resources. The appellate court affirmed. The Supreme Court vacated the appellate court's decision, stating that the Court did not intend for its language regarding "operational purpose" to establish yet another means of identifying a unitary business. The Court remanded the case to the appellate court for further review and declined to rule on whether the businesses were unitary.

GG. Reporting Entity

The Comptroller's rules provide that the reporting entity is primarily responsible for filing the Texas franchise tax reports and paying the tax.

Choice of Reporting Entity

A combined group must identify a reporting entity. The reporting entity will generally be the parent entity, if it is a member of the combined group. If the parent entity is not a member of the combined group, the reporting entity is the entity which has the most activity in Texas for the first year for which a combined report is filed. Activity is based on revenues. The reporting entity will be an entity subject to Texas taxing jurisdiction.

Generally a combined group will choose the parent entity as the reporting entity if it is part of the unitary business. Otherwise, the combined group will generally select an entity that (1) is a combined group member; (2) is subject to Texas' taxing jurisdiction; and (3) has the greatest Texas business activity during the first year that a combined report is required to be filed, as measured by the total revenue for that year.[534]

Practice Pointer: In addition to the combined franchise tax report, each member of a combined group must submit a separate Public Information Report (PIR) or owner information report (OIR) unless the member does not have nexus in Texas.[535] The OIR is Form 05-167. When reporting names on an OIR, Professional associations should check the "OTHER" box and report the members of their executive committee. Trusts should report their trustee information and not check any box (PARTNER or OTHER). Associations should report information for the individuals who have authority to sign a contract on behalf of the association and not check any box (PARTNER or OTHER). All other entities should report their executive board members and check the "OTHER" box.[536]

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[534] Comptroller Rule 3.590(b)(5).

[535] *See* Comptroller FAQ 23. Reports and Payments (Updated 09/21/08), available online at http://www.cpa.state.tx.us/taxinfo/franchise/faq_rpt_pay.html#rpt_pay22.

[536] Comptroller FAQs (Updated 11/15/10).

Rights and Responsibilities

The reporting entity is responsible for timely filing the report and paying the franchise tax. The Comptroller's rules consider any franchise tax elections that the reporting entity makes as binding on the combined group members as well.

The reporting entity is authorized to file refund claims, give waivers and execute agreements on behalf of the combined group. The Comptroller's rules deem any refund claim, waiver given, agreement or any other executed document to have also been provided or executed by each combined group member.

Practice Pointer: The Comptroller may require a reporting entity to provide access to the tax, financial, and nonfinancial records of related entities. This includes entities that do and do not have Texas nexus.

Notice

The Comptroller's rules provide that issuing a notice to the reporting entity is deemed to include all members of the combined group.

Joint and Several Liability

Although a combined group designates a primary reporting entity, the individual members of a combined group remain jointly and severally liable for the filing and reporting requirements.[537]

The Comptroller's rules state that combined group members may also be held jointly and severally liable for any tax reported, plus any penalties and interest due on that tax. Prop. Rule 3.590(g).

Election to Include Disregarded Entity in Combined Group

The Comptroller's rules allow a parent entity to incorporate a disregarded entity's revenues, COGS, compensation and gross receipts as part of its franchise tax computation.

If a parent entity chooses to elect the combination, the Comptroller's rules provide a presumption that the disregarded entity has nexus with the state. Therefore, the disregarded entity's gross receipts that are attributable to Texas would be includible in the numerator of the apportionment fraction.

The election is unavailable if the disregarded entity is passive or otherwise exempt from the franchise tax.[538]

Change in Reporting Entity

The Comptroller's rules state that the reporting entity changes only when the entity is no longer subject to Texas' jurisdiction to tax or the reporting entity is no longer a member of the combined group. There is an exception for parent entities, which can be the reporting entity of the combined group, even if they don't have nexus.

When there is a change in the reporting entity that results from a cessation of business in Texas, the combined group shall designate another qualifying entity as its reporting entity

537 Texas Tax Code § 171.1014(i).

538 Comptroller Rule 3.590(d)(6).

Back to Table of Contents

and notify the Comptroller of the designation.[539]

> **Practice Pointer:** If entities erroneously file separate reports and determine they should have filed a combined report, the entity that filed incorrectly should submit to the Comptroller a letter that identifies its report with its name and taxpayer number. The letter should state that the report was filed in error and notify the Comptroller that the entity will report with a combined group. The letter must also include the name and taxpayer number of the combined group's reporting entity along with a request for a refund or authorization to transfer any tax payment from the member's account to the reporting entity's account. [540]

HH. Consistency Requirements

Combined group members must include activities for the same period used by the combined group. Therefore, entities with different accounting periods for federal tax periods must recompute margin based upon the reporting period elected by the combined group. Also, an entity becoming subject to tax that is a member of a combined group shall include its business activity for the same period as the combined group.

The combined group's accounting year depends upon whether two or more members of the combined group also file a federal consolidated tax return. If they do, the tax year for the combined group will be the tax year for the consolidated return. If not, the federal taxable year of the reporting entity will determine the accounting year for computing the elements of the tax (margin, gross receipts, etc.).

If members of a combined group have different accounting periods, the non-conforming members will need to prepare separate income statements from their books and records for the months included in the combined group's accounting period.

The Comptroller amended Rule 3.590 to clarify that combined groups containing entities with different year-end dates. If the federal tax reporting period of a member differs from the federal tax reporting period of the combined group, the reporting entity will determine the portion of that member's revenue, COGS, compensation, etc. to be included by preparing a separate income statement based on federal income tax reporting methods for the period included in the group's accounting period.

The Comptroller's amended rules also clarify that a combined group will determine its eligibility for the 0.5% tax rate, discounts and E-Z Computation based on the total revenue of the combined group as a whole after eliminations. A final report must be filed if every member of a combined group ceases doing business in Texas.

Example 1.

Corporation A is a separate entity from January 1, 2008 through June 30, 2008. Corp A had $250,000 in total revenue for the period of January 2, 2008 through June 30, 2008.

539 Comptroller Rule 3.590(e)(3).

540 *See* Comptroller FAQ 22. Reports and Payments (Updated 08/11/08), available online at http://www.cpa.state.tx.us/taxinfo/franchise/faq_rpt_pay.html#rpt_pay22.

Back to Table of Contents

On July 1, 2008, Group X acquired Corporation A. Group X owns Corporation A until September 30, 2008. Group X has a March 31, 2008 accounting year-end. On October 1, 2008, Group X sells Corporation A to Group Z. Group Z has a December 31, 2008 accounting year-end.

All entities/groups will file 2009 annual reports based on the following accounting periods:

- Corporation A will file a separate report on its own for the period of January 1, 2008 through June 30, 2008. It does not qualify for a No Tax Due report based on total revenue because its annualized Total Revenue is $500,000, which is greater than the $300,000 threshold.

- Group X will file a combined report on May 15, 2009 based on the period April 1, 2007 through March 31, 2008. It will NOT include Corporation A in the 2009 report because Corporation A was not part of the group during the period upon which the tax is based. It will include Corporation A in its 2010 annual report for the period July 1, 2008 through September 30, 2008.

- Group Z will file a combined report on May 15, 2009 based on the period January 1, 2008 through December 31, 2008 and will include Corporation A's data for the period October 1, 2008 through December 31, 2008.[541]

[541] Comptroller FAQ No. 20. Combined Groups. (Updated 4/10/09). Available online at:

II. Combined Reporting for Entities Starting Business

An entity that is part of a combined group will not report its data on a separate initial report but will include its data with the combined group's report for the corresponding accounting period.[542] The entity should send an initial return notification letter to the Comptroller notifying her of the reporting entity's name.[543]

If the entity was not a member of a combined group for the accounting period that would be covered by its initial report, the entity is required to file a separate initial report for the period that is outside the accounting period that will be used by the combined group.[544]

Example 1.

Corporation A was formed on April 3, 2009 as a member of Combined Group Z. It is spun off as a separate non-unitary entity effective August 15, 2009. The normal accounting year end for all parties is December 31.

Corporation A will file a 2010 initial report due July 1, 2010 for August 15, 2009 through December 31, 2009, the period after the spin-off of the corporation.

Combined Group Z will file a 2010 annual report including Corporation A for April 3, 2009 through August 14,

[542] Comptroller FAQ No. 22. Combined Groups. (Updated 4/10/09). Available online at:
[543] *Id.*
[544] *Id.*

2009, the period before the spin-off of the corporation.[545]

JJ. Combined Reporting for Entities Ceasing Operations

If an entity that is a member of a combined group ceases doing business in Texas, the data that would have been reported on the final report will be included in the combined group's report for the corresponding accounting period. The entity should send final return letter to the Comptroller including notification of the reporting entity's name. [546]

If an entity was *not* a combined group member for the accounting period covered by its final report, the entity *is* required to file a separate final report for any period outside the accounting period used by the combined group.[547]

Example 1.

Corporation C is a separate entity with a December 31 accounting year-end. Combined Group W acquired Corporation C by effective July 1, 2009. Combined Group W also has a December 31 accounting year-end.[548]

On October 31, 2009 Corporation C is dissolved. Corporation C files a final report due December 30, 2009 for the period of January 1, 2009 through June 30, 2009, which is the period before Combined Group W purchased Corporation C. Combined Group W will file a 2010 annual report and include Corporation C for the period July 1, 2009 through October 31, 2009.[549]

Example 2.

Corporation C is a member of Combined Group W. Both Corporation C and Combined Group W have a September 30 accounting year-end.[550]

Corporation C leaves the combined group effective May 1, 2009. On August 15, 2009, Corporation C is dissolved. [551]

Corporation C will file a final report due October 14, 2009 for the period May 1, 2009 through August 15, 2009, which is the period after Corporation C left Combined Group W. Combined Group W will file a 2010 annual report and will include Corporation C for the period October 1, 2008 through April 30, 2009.[552]

KK. Joint and Several Liability

The revised margin tax statute specifies that combined group members are jointly and severally liable for the tax of the combined group. Although a combined group designates a primary reporting entity, the individual members of a combined group remain jointly and severally liable for the filing and reporting requirements.[553] The Comptroller's rules state that combined group members may also be held jointly

545 *Id.*
546 Comptroller's FAQ No. 23. Combined Reporting. Available online at: http://www.cpa.state.tx.us/taxinfo/franchise/faq_comb_rpt.html#comb_rpt1.
547 *Id.*
548 *Id.*
549 *Id.*
550 *Id.*
551 Comptroller's FAQ No. 23. Combined Reporting. Available online at: http://www.cpa.state.tx.us/taxinfo/franchise/faq_comb_rpt.html#comb_rpt1.
552 *Id.*
553 Texas Tax Code § 171.1014(i).

and severally liable for any tax reported, plus any penalties and interest due on that tax.[554]

LL. Water's Edge Reporting

Under Texas law, a legal entity that primarily conducts business outside of the United States must be excluded from the combined group. This rule applies even if the foreign company is an affiliate engaged in a unitary business.

The rule applies when 80% or more of the legal entity's property and payroll are located outside of the United States. In that case, the state considers the entity past the "water's edge," and excludes it from the combined group.[555]

Practice Pointer: Some practitioners call the waters-edge test an "80/20" test because those are the percentages used in determining whether an entity with foreign contacts is includible in a combined group report.

Property Factor

In determining whether an entity is includible in a combined group, the first step is to calculate the property factor. The property factor is a ratio of the property located outside the United States divided by the entity's total property. Property is valued based upon the average value of real and personal property rented or owned. The average value is determined by averaging the value of the property at the beginning and the end of the year for which the entity's margin is measured.

Property the entity owns is valued at its original cost. Property the entity leases or rents is valued at eight times the net annual rental rate. The net annual rental rate equals the amount the entity pays for renting or leasing the property less the amount the entity receives for any sub-rentals or sub-leases.

Payroll Factor

The payroll factor is calculated based on compensation paid during the year for which the entity's margin is measured. The numerator is the total amount paid to persons working outside the United States. The denominator is the total amount of compensation paid during the margin tax measurement year.

Texas considers services to be performed outside the United States if an individual performs entirely outside the United States or if the individual performs services both inside and outside the United States, but the services performed inside the United States is only incidental to the services performed outside the United States.

A service is also considered to be performed outside the United States if some part of the service is performed outside the United States and the operations base or the place from where the service is directed or controlled is outside the United States. A service may be considered to be outside the United States if the base of operations or the place from which the service is directed or controlled is not in any location where some part of the service is performed, but the individual's residence is outside the United States.

554 Comptroller Rule 3.590(g).
555 Texas Tax Code § 171.1014(a).

Back to Table of Contents

No Property or Payroll

If an entity has no property or no payroll, the denominator is one. Therefore, only the payroll or the property will be considered to determine whether the entity can be included in the combined group.

Also, if an entity has no property and no payroll, then the waters edge test is performed using gross receipts. If an entity has no property and no payroll and more than 80% of its gross receipts are apportioned to locations outside the United States, the entity is not includible in the combined group.

Practice Pointer: A foreign entity that is not allowed to be included in a combined group under the waters-edge test may still be subject to the franchise tax if it has nexus with Texas. If nexus exists, the foreign entity is required to file a separate margin tax report without the benefit of intercompany eliminations.

Unitary apportionment and the waters-edge test prevent the manipulation in which taxpayers could engage under a "separate accounting" standard.

A California case involving Barclay's Bank, PLC applied the waters-edge test to a United Kingdom corporation in the Barclays Group, which is a multinational banking business.[556] The case also considered the proper unitary treatment for Colgate-Palmolive, the US-based parent of a multinational manufacturing and sales business.

[556] Barclay's Bank PLC v. Franchise Tax Bd. Of Cal., 512 U.S. 298 (1994).

The court determined that the Constitution didn't impede application of California's corporate franchise tax to these two multinational companies. The Court discussed the need for unitary (waters-edge) apportionment, rather than a separate accounting:

"Separate accounting poses the risk that a conglomerate will manipulate transfers of value among its components to minimize its total tax liability. To guard against such manipulation, transactions between affiliated corporations must be scrutinized to ensure they are reported on an 'arms-length' basis, *i.e.*, at a price reflecting their true market value."

MM. Oil & Gas Industry Summary

The margin tax includes several special provisions which benefit the oil & gas industry. The industry may benefit from COGS deductions and special revenue exclusions. Since the oil and gas industry is capital-intensive, it was conceivable at the time the legislature enacted that statute that they could benefit from reductions in property taxes that were anticipated as a result of the new margin tax.

Operators and Producers

The margin tax statute offers oil and gas operators benefits by expanding the costs of goods sold that may be deducted and by offering revenue exclusions for low-producing wells when the prices of oil and gas drop below certain levels. While operators and producers most likely would elect the COGS deduction, if they elected to deduct compensation, they could include net distributive income paid to natural person partners. The Comptroller has clarified that entities that drill for oil and gas are allowed a COGS deduction because oil and gas extraction falls under the definition of "production" in Texas Tax Code § 171.1012(a)(2).

Cost of Goods Sold. Studies show that federal costs of goods sold for oil and gas producers and refiners average 79.9% of total revenues. In addition to those expenses generally includible for federal tax purpose, the margin tax deduction also allows oil and gas producers to deduct intangible drilling costs, dry hole costs and geological and geophysical costs.

Intangible drilling costs are costs incurred in connection with drilling and preparing wells for the production of oil, gas, or geothermal energy.[557] They include payments for wages, fuel, repairs, hauling, supplies, and other items, which are incidental to, and necessary for, well preparation and drilling.[558]

For federal tax purposes, taxpayers generally have an option of deduction as ordinary and necessary or capitalizing intangible drilling costs.[559]

For margin tax purposes intangible drilling costs and dry hole costs are part of the eligible costs of good sold.[560] Deductible expenses include the cost of renting or leasing equipment and facilities.[561]

557 BNA Portfolio 605-1st, Oil and Gas Transactions, § III.C.1.a.
558 *Id.*
559 *Id.*
560 HB 3, Texas Tax Code § 171.1011(c).
561 HB 3, Texas Tax Code § 171.1011(c)(7).

Geological and geophysical ("G&G") costs incurred to identify and locate property with mineral-producing are deductible as COGS.[562] Operators incur G&G costs in order to obtain data necessary to determine whether to acquire or maintain a particular lease.[563] For federal tax purposes, taxpayers are generally required to capitalize G&G costs and amortize them over a period over a period of years.[564] The period is generally twenty-four (24) months for costs incurred in connection with U.S. oil & gas exploration.[565] This period is extended to five (5) years for major integrated oil companies' costs incurred after May 17, 2006.[566]

Costs of goods sold also include the costs of repairing and maintaining pollution control devices.[567]

Low-Producing Wells. The margin tax also allows exclusions from revenues for low-producing oil and gas wells. Taxable entities may exclude from margin total revenues received from oil or gas produced by a low-producing well during certain dates certified by the Comptroller.[568]

In order to qualify, the production of an oil well designated by the Texas Railroad Commission or similar out-of-state authority as a low-producing well must average less than 10 barrels a day over a 90-day period.[569] A gas well similarly designated must average less

562 HB 3, Texas Tax Code § 171.1011(c)(10).
563 BNA Portfolio 605-1st, § III. B.3. & C.2.
564 *Id.*
565 *Id.*
566 *Id.*
567 HB 3, Texas Tax Code § 171.1011(c)(9).
568 HB 3. Texas Tax Code § 171.1011(r).
569 HB 3. Texas Tax Code § 171.1011(r)(1).

Back to Table of Contents

than 250 mcf a day over a 90-day period.[570]

In addition, the prices must drop below certain levels. Before low producing well revenue may be excluded, the monthly average closing price of West Texas Intermediate crude oil must drop below $40 per barrel. The average closing price of gas must drop below $5 per MMBtu. These amounts are recorded on the New York Mercantile Exchange (NYMEX).[571] Beginning November 2010, the Comptroller certifies and publishes low producing well information on a monthly basis in the Texas Register.

Payments to Owners. If an operator or producer elects to deduct compensation rather than COGS, payments made to natural person partners in oil and gas agreements are deductible as wages and compensation up to $320,000 per person beginning January 1, 2010.

Oil & Gas Investors

Oil and gas investors may receive passive entity treatment if their receipts from oil and gas interests, along with other passive sources, make up at least 90% of their total revenues.[572] For margin tax purposes, the ownership of a royalty interest or a nonoperating working interest in mineral rights does not constitute conduct of an active trade or business.[573]

Eligible oil and gas payments include royalties, bonuses, or delay rentals from mineral properties and income from other nonoperating mineral interests. A nonoperating mineral interest is generally one in which the investor may share in profits and incur costs in connection with the investment, but does not direct the operations of the well or lease.[574]

In order for the entity to qualify as passive, the entity must not be affiliated with the operator. An entity is affiliated if it shares more than 50% common ownership or control with the operator.[575]

Well Servicing Companies

Texas Tax Code § 171.1012 allows taxpayers to deduct costs incurred in connection with the production of goods for sale. For Texas franchise tax purposes, "goods" means "real or tangible personal property sold in the ordinary course of business of a taxable entity."[576] "Production" includes "construction, installation, manufacture, development, mining, extraction, improvement, creation, raising, or growth."[577]

The Comptroller's office agrees that oil wells constitute real property for purpose of the COGS deduction.[578] The Comptroller's office also agrees that contract drilling and completion of oil and gas wells constitutes construction, improvement, remodeling, repair or

570 HB 3. Texas Tax Code § 171.1011(r)(2).
571 HB 3. Texas Tax Code § 171.1011(s).
572 Texas Tax Code § 171.0003(a)(2)(D).
573 Texas Tax Code § 171.0004(e)(1).

574 Texas Tax Code § 171.0003(a)(2)(D).
575 Texas Tax Code § 171.0003(b)(2).
576 Texas Tax Code § 171.1012(a)(1).
577 *Id* at § 171.1012(a)(2).
578 *See* Comptroller's Letter 200811216L (Teresa Bostick – Nov. 17, 2008). The Comptroller's tax policy representatives initially treated oil and gas well servicing companies as service providers.

industrial maintenance of real property.[579]

Moreover, the Comptroller's tax policy division has stated that "oilfield services that Taxpayer performs for the construction, improvement, remodeling, repair, or industrial maintenance of oil and gas wells can be included in the Taxpayer's COGS deduction for allowable costs under Tax Code Sec. 171.1012."[580] This includes costs related to the provision of oil field services for the construction, improvement, remodeling, repair or industrial maintenance of oil and gas wells.[581] The Comptroller considers the components of oil and gas wells to be real property for franchise tax purposes to the extent they are considered real property for sales and use tax purposes after installation.[582]

Texas Tax Code § 171.1012(c) allows COGS deductions for all direct costs of acquiring or producing goods. This includes, among other things, labor costs,[583] handling costs, inbound transportation costs,[584] costs associated with renting or leasing equipment,[585] and costs attributable to research, experimental engineering and design activities, directly related to the production of goods.[586] Texas Tax Code § 171.1012(h) states that a taxable entity shall generally determine its cost of goods in accordance with federal income tax methods.

579 *Id.* at Response to Question 2.
580 *Id.* at Response to Question 3.
581 *Id.* at Response to Question 4.
582 Comptroller FAQs (Updated 9/9/2011).
583 Texas Tax Code § 171.1012(c)(1).
584 *Id.* at (c)(4).
585 *Id.* at (c)(7) and (8).
586 *Id.* at (c)(9).

Many well servicing companies pay their workers as Form 1099 contractors, and therefore would be ineligible to a compensation deduction for those payments.

Pipeline Companies

Pipeline companies are generally considered service providers. They are generally considered transporters of goods. On average, pipelines incur approximately 61.4% of revenues in COGS and approximately 11% in compensation.

Since they don't own the goods transported, they're ineligible for the COGS deduction. Therefore, pipeline companies will likely be relegated to the 30% deduction from revenues.

Oil and Gas Conglomerates

Oil and gas companies commonly organize into vertically-integrated groups of related entities. This presents special issues.

The first issue is whether the members of the vertically-integrated enterprise will be required to form a combined report. This will depend upon the ownership of the entities. If there is more than 50% common ownership and control, they'll be considered an affiliated group.

If an affiliated group is engaged in a unitary business, the members must share information and file a combined report. As discussed in the chapter on combined reporting and unitary businesses, it's common for vertically-integrated oil and gas groups to be considered unitary. Their worldwide income is generally includible in the

Back to Table of Contents

combined group report, except to the extent it is generated outside the United States under the waters-edge test, also discussed in the combined reporting and unitary tax chapter.

The second issue is whether the group will qualify as a retailer or wholesaler, and therefore be eligible for the reduced rates. In order to qualify as a retailer or wholesaler, less than 50% of revenues may originate from goods the entity or group of entities produces. One issue will be whether the test is performed before or after intercompany payments are deducted from the combined group's revenues.

A third issue is whether the entities will be eligible to deduct COGS. Generally, the COGS deduction will be available to members of affiliated groups if at least one member owns the goods. Therefore, while a well servicing operation or pipeline company generally wouldn't qualify for the COGS deduction, they may be able to take advantage of combined reporting and be eligible for COGS treatment if a related entity owns the goods produced for sale.

Chapter VI. Selected Issues

A. Introduction

This section discusses selected Texas state tax issues affecting the oil and gas industry. Certain purchases or sales by taxpayers in the oil and gas industry may be exempt from sales & use tax and taxable under the oil well servicing tax,[587] the gas severance tax, or the motor fuels tax.

Invoice Descriptions. The taxability of oil and gas well services depends upon the type of the service and the reason for the service. Therefore, it's important to include as much information as possible in the invoice description.[588]

Whether a particular service is subject to tax generally depends on the overall reason for performing the service. If a service is part of the initial drilling of a well or the workover of a well, it is generally not taxable. Repairs of tangible personal property are generally taxable, but may not be subject to tax if they are done as part of the workover of a well.

The auditor should be able to tell from the invoice description whether a particular service is taxable.

B. Property Tax

Underground Structures. Manmade underground structures may be taxed separately from the land on which they're situated. The case of *Matagora County Appraisal District v. Coastal Liquids Partners*,[589] considered whether manmade salt dome caverns could be appraised and taxed separately from the land above them. The salt dome caverns had been built for storing liquid hydrocarbons. The Property Tax Code defines "real property" as:

- Land;
- An improvement;
- A mine or quarry;
- A mineral in place;
- Standing timber; or
- An estate or interest in one of the above.

Some aspects of real property can be taxed separately even though they are part of the same surface tract. In the *Coastal Liquids* case, the taxpayers sought to have the salt dome caverns taxed separately from the land because Coastal was leasing the caverns from Texas Brine Corporation and was required to pay the property tax on the caverns under the terms of the lease. The court determined that the salt dome caverns were real property improvements because they were manmade. The court also determined that they could be assessed and taxed separately from the attached real property.

C. Fuel Tax

History of IFTA. The general guiding principles of IFTA were to simplify and coordinate what had been an even more complicated system of taxation. Congress passed the

[587] The oil and gas well servicing tax is a 2.42% occupation tax levied upon individuals who service the wells.
[588] Comptroller's Letter No. 9803236L.
[589] 48 Tex. Sup. J. 784 (2005).

Back to Table of Contents

Intermodal Surface Transportation Efficiency Act of 1991 (ISTEA),590 which required all states to come into compliance with the International Fuel Tax Agreement (IFTA) by 1996.[591] Before IFTA, fuel use tax nonconformity in state tax laws, regulations and administrative practices was a major problem.

In 1985, the National Governors' Association (NGA) and the National Conference of State Legislatures (NCSL), along with many individual state and industry representatives worked with the U.S. Department of Transportation (US DOT) on a three-year study, known as the Working Group on State Motor Carrier Procedures.[592] Their goal was to relieve motor carriers from the costs of nonuniformity between states by forming a consensus among the states.[593] The consensus agreement eventually became IFTA.[594]

By 1990, only fourteen states were IFTA members.[595] The U.S. Supreme Court's decision in *American Trucking Associations, Inc. v. Scheiner*,[596] prompted renewed interest in an integrated nationwide fuel use tax system. The Supreme Court ruled that states could not constitutionally impose a flat per-vehicle fee on interstate motor carriers because that fee would necessarily discriminate against carriers who operate across state lines.[597]

ISTEA effectively required each of the continental United States to join IFTA, but it left the states in charge of fuel use tax administration.[598] It stated that states may not impose fuel tax reporting or payment requirements after September 30, 1996, that aren't in compliance with IFTA.[599] IFTA has removed much of the previous burden of state nonuniformity by creating a base-state system, in which one state acts as agent for the others in tax collection and compliance monitoring.[600] IFTA also defines the types of vehicles to which it applies. However, states still set their own rates and are responsible for enforcement.[601] Amending the IFTA agreements requires a three-quarters vote of member states and provinces. A board of trustees governs IFTA, Inc., an incorporated repository in Tempe, Arizona.[602] The trustees are state and provincial fuel tax administrators elected by their peers.

The IFTA Articles of Agreement[603] state that jurisdictions may define certain use of fuel as exempt.[604] The IFTA Agreement also states that licensees must submit claims for refund paid on tax-exempt fuel directly to the respective jurisdiction.[605]

590 P.L. 105-277 §§ 1100-1104, codified at 49 U.S.C. § 347 *et. seq.*

591 Robert C. Pitcher, *The International Fuel Tax Agreement: Are There Lessons Here for Sales and Use Taxation*, State Tax Notes, Vol. 20, No. 11 (March 11, 2001) *at* http://www.zrlaw.com/publications/articles/rcp0103.htm. (hereinafter "Pitcher article")

592 *See* Pitcher article.

593 *See* Pitcher article.

594 *See* Pitcher article.

595 *See* Pitcher article.

596 483 U.S. 266 (1987).

597 *Id.*

598 *See* Pitcher article.

599 *See* Pitcher article. (citing ISTEA § 4008)

600 *See* Pitcher article.

601 *See* Pitcher article.

602 *See* Pitcher article.

603 Adopted January 1996, effective July 1, 1998, revised July 2002, corrected January 2003.

604 IFTA Articles of Agreement, R830.001.

605 IFTA Articles of Agreement, R830.002.

In compliance with ISTEA, Texas became a member of IFTA as of July 1, 1995.[606] Texas assesses tax on the first sale or use of diesel fuel in this state.[607] The tax rate is twenty cents per gross gallons of fuel sold or used in this state.[608] Taxpayers may receive refunds of tax paid for any purpose other than propelling a motor vehicle on the public highways of this state.[609] Texas law also states that the Comptroller may approve a device for measuring diesel fuel that the taxpayer uses for powering auxiliary power units or power take-off equipment while stationary.[610]

Calculating Fuel Used. Texas Tax Code § 153.207 (d) states that "the number of gallons of diesel fuel used on Texas highways shall be computed by dividing the total miles traveled in all states by the total number of gallons of diesel fuel delivered into the fuel supply tanks of the motor vehicle in all states. The mileage factor obtained shall be divided into Texas miles traveled in order to determine the number of gallons of diesel fuel used in Texas." IFTA and the Texas statutes require a taxpayer to maintain certain records and documents from which IFTA auditors may calculate MPG.

The IFTA Audit Manual provides for fuel use estimation "[i]f the licensee's records are lacking or inadequate to support any report filed by the licensee or to determine the licensee's tax liability … ."[611] The methods that the IFTA audit manual lists as bases for estimating the fuel tax liability are:

- Prior experience of the licensee;
- Licensees with similar operations;
- Industry averages;
- Records available from fuel distributors; and
- Other pertinent information the auditor may observe.

The manual also states that "[u]nless the auditor finds substantial evidence to the contrary by reviewing the above, in the absence of adequate records, a standard of 4 MPG/1.7KPL will be used."

Refunds and Credits. Texas Tax Code § 153.222 allows a refund for taxes paid on excepted uses of diesel fuel. A taxpayer may file a claim for refund for taxes paid for "any purpose other than propelling a motor vehicle on the public highways of this state … ." In addition, users who pay tax on diesel fuel used in motor vehicles equipped with auxiliary power units or power take-off equipment may file claims for refund for motor fuels tax used in this state. The refund applies only to vehicles equipped with measuring devices or methods designed to separately measure the fuel used to power the equipment.

Comptroller's Rule 3.173 (d) (9) sets forth various methods a fuel user may adopt to comply with this requirement. However, multi-state fuel users must claim exemptions separately in each state where they have exempt fuel use.

IFTA states that licensees "shall receive full credit or refund for tax-paid fuel used outside the jurisdiction where the fuel was purchased. The base

606 *See* Motor Fuels Tax Audit Procedures Manual, page 3.
607 Texas Tax Code § 153.201.
608 Texas Tax Code § 153.202.
609 Texas Tax Code § 153.222 (a).
610 Texas Tax Code § 153.222 (b).
611 *See* IFTA Audit Manual § A550.001. Fuel Use Estimation.

Back to Table of Contents

jurisdiction shall allow credits and issue refunds for all of its licensees on behalf of all member jurisdictions."[612] However, IFTA also states that "[l]icensees must submit claims for refund for tax paid on tax-exempt fuel directly to the respective jurisdiction.[613] The statutes of limitations for the various states may vary.

D. Enforcement and Collection of Motor Fuel Taxes

Effective September 1, 2009, the legislature amended the definitions of biodiesel fuel, blending, bulk storage, diesel fuel, distributor, gasoline, gasoline blended fuel and motor fuel to enhance the prosecution of criminal motor fuel tax fraud and makes clear who is liable for motor fuel taxes. "Bulk storage" is storage in a container in excess of 10 gallons.[614]

A motor fuel transporter license is no longer required for persons licensed as suppliers, permissive suppliers or distributors if they only transport motor fuel for which they retain title. Shipping documents are required in conjunction with the sale, transfer or transportation of motor fuel, regardless of where the motor fuel is obtained.

A supplier or permissive supplier license is no required to enter into tax-free transactions in the bulk terminal/transfer system. A supplier license is required for position holders who remove or take orders for the removal of motor fuel from a terminal located in Texas.

A sales invoice must separately state the amount of state motor fuels tax collected so that the tax is ultimately paid by the end consumer. A separate statement is not required on a sales invoice issued by a dealer when the delivery is into a fuel supply tank or a container having a capacity of 10 gallons or less.

A license holder may claim a tax credit on gasoline or diesel fuel sold to certain exempt entities through the acceptance of a credit card not issued by the license holder, if the credit card issuer did not collect the tax from the exempt entity and the license holder reimbursed the card issuer for the amount of the tax included in the retail purchase price. Exempt entities that qualify for this treatment are: the U.S. government, Texas public school districts, commercial transportation companies using the motor fuel to provide transportation services for Texas public school districts, Texas volunteer fire departments and non-profit electric and telephone cooperatives organized under Chapters 161 or 162, Utilities Code.

An end user may purchase up to 10,000 gallons of exempt died diesel fuel in a calendar month, and an agricultural end user may purchase up to 25,000 gallons in a calendar month, regardless of whether the purchase is made in a single delivery or multiple deliveries. If multiple deliveries are made, the last delivery in a calendar month that causes the purchaser to

612 IFTA Articles of Agreement § R1100.

613 IFTA Articles of Agreement R830.200. Note: The rationale may be that only the refund state can properly analyze its laws to determine if a refund is justified.

614 Senate Bill 1495 (Effective Sept. 1, 2009). Statutory references in affected codes have been changed from Chapter 153 to Chapter 162, Tax Code.

Back to Table of Contents

exceed the 10,000 or 25,000 gallon limitation is still a tax-free delivery.[615]

A licensed seller may temporarily rely on the Comptroller's Web site list of end user numbers, or other materials provided by the Comptroller, to make a tax-free signed statement sale of dyed diesel fuel until the purchaser provides the seller a completed signed statement. The Comptroller may issue a written request giving the seller 60 days to provide copies of the seller's signed statements. The Comptroller may disallow tax-free sales of dyed diesel fuel on which the seller cannot deliver copies of the signed statement within the 60-day period.

Licensed distributors, importers, exporters or blenders that erroneously overpaid gasoline or diesel fuel taxes have four years to amend the tax return on which the taxes were overpaid.

E. Deferred Payments and Accelerated Credits

Licensed distributors and importers may defer payment of tax to a supplier or permissive supplier until two days before the date the supplier or permissive supplier must remit the tax to the Comptroller.

Effective June 19, 2009, licensed suppliers and permissive suppliers may request a 100% accelerated credit on taxes that weren't paid by the distributor or importer, but only if the supplier or permissive supplier notifies the Comptroller within 15 days of the date of default.

Example. A supplier or permissive supplier may claim a 100% accelerated credit no later than July 8, 2009, for taxes defaulted by a distributor or importer on June 23, 2009.[616]

Distributors and importers that default on a tax payment to a supplier or permissive supplier lose their right to defer tax payments to that supplier or permissive supplier for one year from the date the supplier or permissive supplier claims the accelerated credit.

A supplier or permissive supplier who does not claim an accelerated credit within 15 days of the default may still claim a bad debt credit after the account is written off as uncollectable on the supplier's or permissive supplier's books. When claiming a bad debt credit, a supplier or permissive supplier must ratably apply all payments received on an account between products sold and taxes.

F. Biodiesel and Renewable Diesel Fuel Notices

Biodiesel, renewable diesel and for the volume of biodiesel or renewable diesel blended with taxable diesel fuel is tax exempt to the ultimate consumer.[617]

The sales invoice for each sales transaction after the biodiesel or renewable diesel is produced and is first blended with taxable diesel fuel must identify the volume of biodiesel and renewable diesel and the volume of biodiesel or renewable diesel that is

[615] The 7,400 gallon single delivery limitation on the signed statement purchase of tax-free dyed diesel fuel was eliminated effective September 1, 2009.

[616] Senate Bill 1782 (Effective June 19, 2009).

[617] Tax Code § 162.204.

Back to Table of Contents

combined with taxable diesel fuel. This identification must continue on each sales invoice until the products are sold to the ultimate consumer.[618]

A wholesaler must identify on each sales invoice the volume of biodiesel or renewable diesel that is combined with taxable diesel fuel showing the number of gallons of biodiesel or renewable diesel, rounded to the nearest whole gallon, or by the percentage of biodiesel or renewable diesel, rounded to the nearest whole percentage. This is mandatory. The sales invoice must also indicate the state tax collected on each sale based on the volume that is taxable petroleum-based diesel fuel.

Dealers are required to identify on each sales invoice the volume of biodiesel and renewable diesel sold through a retail pump to the ultimate consumer. On retail sales to the ultimate consumer that contain 20% or less biodiesel or renewable diesel, the dealer may identify the blended product sold as

- "Contains up to 5% biodiesel or renewable diesel - state diesel tax $0.19 per gallon" or
- "Contains up to 10% biodiesel or renewable diesel - state diesel tax $0.18 per gallon" or
- "Contains up to 15% biodiesel or renewable diesel - state diesel tax $0.17 per gallon" or
- "Contains up to 20% biodiesel or renewable diesel - state diesel tax $0.16 per gallon."

On blends that contain more than 20% biodiesel or renewable diesel fuel, the volume must be identified to the nearest whole gallon or nearest whole percentage, with the appropriate state diesel tax rate. Identifying the volume of biodiesel and renewable diesel fuel on a sales invoice when sold by a dealer through a retail pump is not an option.[619]

G. Used Oil Collection Centers.

The Comptroller has established special automotive oil sales fee reporting requirements for distributors that sell automotive oil through locations registered with the TCEQ as a Used Oil Collection Center.[620]

Texas imposes the automotive oil sales fee on the first sale of automotive oil in Texas.[621] The fee is one cent per quart or four cents per gallon.

A "first sale" means the first actual sale of automotive oil delivered to a location in this state and sold to a purchaser who is not an automotive oil manufacturer or distributor.[622] A "first sale" does not include the sale of automotive oil to a subsequent purchaser who maintains a "do-it-yourself" used oil collection center or a TCEQ-registered used oil collection center at the location where the automotive oil is changed, used, consumed or resold to "do-it-yourselfers." In order to prove an exemption, the distributor should keep a

[618] *See* Comptroller Rule 3.433, which details the information required on each sales invoice issued by wholesalers (refiners, producers, blenders, importers resellers) and retail dealers.

[619] Tax Policy News, May 2012.

[620] Tax Policy News, January 2010.

[621] Texas Health and Safety Code § 371.062.

[622] *Id.* at § 371.062(a)(2).

Back to Table of Contents

copy of the purchaser's current TCEQ registration.[623]

Example. A company sells automobile parts, equipment, oil and transmission fluid to lube centers, car dealerships, parts stores, repair shops and individuals. The company sells more the 25,000 gallons of automotive oil a year and has an automotive oil distributor's permit.[624] All of the distributor's automotive oil is sold at the distributor's location. The location is also a TCEQ-registered used oil collection. Since sales of automotive oil by a registered used oil collection center are excluded from the fee, the company does not owe the automotive sales fee report.[625] However, under Comptroller Rule 3.701(f)(2), the distributor must still file a quarterly report even when no tax is due. Although automotive oil sold from a TCEQ-registered used oil collection center is not, by definition, a first sale, the company is a distributor and must file a report. The distributor may report zeros for automotive oil sold at a location registered with the TCEQ as a used oil collection center. TCEQ registrations and sales records showing automotive oil sales were made at the registered location are proof of exempt oil sales.[626]

623 *See* Comptroller Rule 3.701(b)(2).
624 Texas Health and Safety Code § 371.062(m).
625 Comptroller Letter No. 200911559L.
626 *See also* Comptroller Letter Nos. 200107377L and 9509870L.

Back to Table of Contents

SECTION OF TAXATION
State Bar of Texas

September 26, 2012

VIA U.S. MAIL

Mr. Douglas H. Shulman
Commissioner
Internal Revenue Service
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Comments on Proposed Regulation relating to property transferred in connection with the performance of service under Section 83 of the Internal Revenue Code

Dear Commissioner Shulman:

On behalf of the Section of Taxation of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Department of the Treasury and the Internal Revenue Service for comments concerning the proposed regulations relating to property transferred in connection with the performance of service under section 83 of the Internal Revenue Code of 1986, as amended.

THE REQUEST FOR ADDITIONAL GUIDANCE AND ACCOMPANYING COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE SECTION OF TAXATION OF THE STATE BAR OF TEXAS. THIS REQUEST AND THESE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE SECTION OF TAXATION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW. THE REQUEST FOR THE ISSUANCE OF ADDITIONAL GUIDANCE AND ACCOMPANYING COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSION OF THE SECTION OF TAXATION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE SECTION OF TAXATION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED FOR

Back to Table of Contents

THIS REQUEST FOR ADDITIONAL GUIDANCE AND ACCOMPANYING COMMENTS AND THIS REQUEST AND THESE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE SECTION OF TAXATION WHO PREPARED THEM.

We commend the Service for permitting us to submit this request for additional guidance, and we appreciate being extended the opportunity to participate in this process.

Sincerely,

Tina R. Green

Tina R. Green
Chair, Section of Taxation
State Bar of Texas

Back to Table of Contents

RESPONSE TO REQUEST FOR COMMENTS REGARDING PROPOSED REGULATIONS RELATING TO THE TRANSFER OF PROPERTY IN CONNECTION WITH THE PERFORMANCE OF SERVICES UNDER SECTION 83 OF THE INTERNAL REVENUE CODE

This response to the request for comments in the notice of proposed rulemaking, REG 141075-09, relating to property transferred in connection with the performance of services under section 83 of the Internal Revenue Code of 1986, as amended (the "Code"), is presented on behalf of the Section of Taxation of the State Bar of Texas. The principal drafters of these comments are Heather C. Panick and Henry Talavera, who are both Vice-Chairs of the Employee Benefits Committee, along with Jeffry Blair, the Chair of the Corporate Tax Committee. The Committee on Government Submissions ("COGS") of the Section of Taxation of the State Bar of Texas has approved these comments. Substantive comments were provided by Stephanie M. Schroepfer and Susan A. Wetzel. Stephanie M. Schroepfer is the Chair of COGS and Susan A. Wetzel is the Chair of the Employee Benefits Committee on behalf of COGS. Mark A. Bodron reviewed these comments on behalf of COGS.

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

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Date: September 26, 2012

Back to Table of Contents

This comment letter is in response to the request of the Internal Revenue Service (the "IRS") and the Department of the Treasury for comments concerning the notice of proposed rulemaking, REG 141075-09, relating to property transferred in connection with the performance of services under section 83 of the Code (the "Proposed Regulation").

Section 1.83-3(c) of the Proposed Regulation would rewrite the existing guidance concerning the types of restrictions that may create a substantial risk of forfeiture (an "*SRF*") sufficient to defer income recognition for federal income taxation purposes.

In general, the Proposed Regulation specifies that whether property is subject to an SRF depends upon the facts and circumstances. The Proposed Regulations further state that an SRF exists:

- *Only* where rights in transferred property are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person, or upon the occurrence of a condition related to the purpose of the transfer; and

- the possibility of forfeiture is substantial.

Use of the Term "Only"May Result in a Narrowing of Permissible SRFs

We respectfully suggest that the IRS and the Treasury revise section 1.83-3(c) of the Proposed Regulation by replacing the words "exists only" with the words "is presumed to exist".

We are concerned that the insertion of the word "only" would turn a current regulatory example of facts and circumstances, which might create an SRF, into an exclusive list of circumstances which create an SRF. As written under the Proposed Regulations, those circumstances must relate directly or indirectly to future performance (or refraining from performance) of substantial services by any person or a condition related to the purpose of the transfer. We find no support in the legislative history for this narrowing of the Treasury Regulations as currently written. We believe that there could be other circumstances under which an SRF may occur based on the particular facts, as was recognized by the IRS and the Treasury when the Treasury Regulations were initially drafted. We suggest that the reason the Treasury Regulations were initially drafted as they are was to provide flexibility in crafting SRFs.

Involuntary Separation as SRF

We respectfully suggest that in finalizing the Proposed Regulation, the IRS and the Treasury consider expressly clarifying that, under appropriate facts and circumstances, an involuntary separation may qualify as an SRF. We suggest that the IRS and the Treasury consider adding language relating to involuntary separations that is similar to language contained in the Treas. Reg. §1.409A-1(d)(1).

For purposes of section 409A of the Code, Treas. Reg. §1.409A-1(d)(1) expressly states that "[i]f a service provider's entitlement to the amount is conditioned on the occurrence of the service provider's involuntary separation from service without cause, the right is subject to a substantial risk of forfeiture if the possibility of forfeiture is substantial." For purposes of section 409A of the Code, the IRS and the Treasury generally defined an involuntary separation from service as a separation from service due to the independent exercise of the unilateral authority of the service recipient to terminate the service provider's services. Treas. Reg. §1.409A-1(n)(1). For purposes of section 409A of the Code, the IRS and the Treasury state that a service provider's voluntary separation from service will be treated as an involuntary separation from service in certain limited circumstances where the voluntary separation from service under the conditions effectively constitutes an involuntary separation from service. Treas. Reg. §1.409A-1(n)(2). In order for a "good reason" voluntary resignation to qualify as an involuntary separation from service for purposes of section 409A of the Code, the resignation must be due to an action taken by the service recipient that results in a material, negative change to the service provider in the service relationship, such as the duties to be performed, the conditions under which the duties are to be performed, or the compensation to be received for performing such services. *Id.*

The specific inclusion of language related to involuntary separations from service in the definition of an SRF for purposes of section 409A coupled with the absence of any reference to involuntary separations from service in the definition of an SRF for purposes of section 83 could lead to confusion concerning whether, in appropriate circumstances, an involuntary separation from service may qualify as an SRF for purposes of section 83.

Accelerated Vesting Upon Involuntary Separation Does Not Destroy Otherwise Valid SRF

We respectfully suggest that, in finalizing the Proposed Regulation, the IRS and the Treasury consider expressly clarifying that, under appropriate facts and circumstances, the inclusion of language in a compensatory transfer of property award that an SRF will lapse immediately upon the occurrence of an involuntary separation will not adversely affect the status of the SRF for federal income taxation purposes. Similar to situations addressed in private letter rulings, compensatory transfers of property are commonly designed to provide for SRFs based upon requirements to provide substantial future services, coupled with features for accelerated vesting upon the occurrence of involuntary separations.

Back to Table of Contents

SECTION OF TAXATION
State Bar of Texas

August 23, 2012

via email to bryant.lomax@cpa.state.tx.us

Mr. Bryant Lomax
Texas Comptroller of Public Accounts
Manager, Tax Policy Division
P.O. Box 13528, Capitol Station
Austin, Texas 78711-3528

RE: **Response to Comptroller Request for Comments Concerning Proposed Amendments to Rules 3.1 and 3.10**

Dear Mr. Lomax:

On behalf of the Section of Taxation of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Texas Comptroller of Public Accounts for comments pertaining to proposed amendments to Comptroller Rules 3.1 and 3.10.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE SECTION OF TAXATION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE SECTION OF TAXATION, WHICH HAS SUBMITTED THIS LETTER, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW. THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENTAL SUBMISSIONS OF THE STATE BAR OF TEXAS SECTION OF TAXATION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE SECTION OF TAXATION MEMBERS WHO PREPARED THEM.

Back to Table of Contents

We greatly appreciate the opportunity to work with your office on these significant tax issues and hope to provide relevant analysis for your review. Thank you for your consideration.

Respectfully submitted,

Tina R. Green

Tina R. Green
Chair, Section of Taxation
The State Bar of Texas

Back to Table of Contents

RESPONSE TO REQUEST FOR COMMENTS REGARDING PROPOSED AMENDMENTS TO COMPTROLLER RULES 3.1 AND 3.10

This response to request for comments with respect to proposed amendments to Comptroller Rules 3.1 and 3.10 is presented on behalf of the Section of Taxation of the State Bar of Texas (the "Section"). The principal drafters of these comments are the Chair and Vice Chairs of the Section's Committee on State and Local Taxation: Ira Lipstet, Charolette Noel, Sam Megally and Matt Hunsaker. The Section's Committee on Government Submissions ("COGS") has approved these comments. Stephanie Schroepfer, the Chair of COGS, and Alyson Outenreath, officer of the Section, reviewed this response to request for comments on behalf of COGS.

Although many of the persons who participated in preparing this letter have clients who would be affected by the state tax principles addressed by this letter or have advised clients on the application of such principles, no such person (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of this letter.

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Date: August 23, 2012

Back to Table of Contents

I. EXECUTIVE SUMMARY

This comment letter is in response to the request of the Texas Comptroller of Public Accounts (the "Comptroller") for comments concerning proposed amendments to 34 Tex. Admin. Code §§ 3.1 and 3.10 relating to private letter rulings and general information letters ("Proposed Rule § 3.1")[1] and the Taxpayer Bill of Rights ("Proposed Rule § 3.10") (together Proposed Rule § 3.1 and Proposed Rule § 3.10, referred to as "the Proposed Rules").

II. INTRODUCTION

We recognize and appreciate the challenges facing the Comptroller when balancing limited resources with the tasks of providing useful and reliable taxability guidance, prompt and accurate answers to taxpayers' questions, and information that promotes voluntary compliance with state tax laws. We also want to express our appreciation to the Comptroller personnel for their efforts to encourage a dialog on the issues addressed in the Proposed Rules. We recognize and appreciate that the Comptroller has thoughtfully considered suggestions and comments in recent discussions with interested parties and has incorporated many, if not most, of the comments raised in those discussions. It is our intent to present items for further consideration that may help and support the Comptroller personnel to more efficiently and effectively perform these important tasks.

The focus of these comments is on the modification and/or addition of Rule provisions that dictate what type of documentation must be provided to obtain requested guidance, which type of written guidance taxpayers may rely upon to avoid interest and penalties, and when a taxpayer has the right to communicate with the Tax Policy Division before the Division makes a determination on disputed positions and characterizations involving the taxpayer. The following are our comments and suggestions addressing these issues for consideration by the Comptroller.

III. PROPOSED RULE § 3.1 COMMENTS

According to the preamble, the Comptroller's office has proposed a new Proposed Rule § 3.1 concerning private letter rulings and general information letters 1) to distinguish between the types of communications that reflect guidance that is already available in the form of rules, publications or other agency resources and the type of communication where guidance is not already provided by law or by the Comptroller, and 2) to comply with the court ruling regarding the statutorily-required rulemaking process as set forth in *Combs v. Entertainment Publ'ns, Inc.*, 292 S.W.3d 712 (Tex.App.—Austin 2009, no pet.). Proposed Rule § 3.1 describes certain situations when a "related person" may rely upon, or may be prohibited from obtaining, certain guidance from the Comptroller. The provisions of Proposed Rule § 3.1(c) and § 3.1(d) correspond with revisions to Proposed Rule § 3.10, which we address in Section IV below.

We appreciate the Comptroller's efforts to establish Rules as to the circumstances in which a taxpayer may and, at least as importantly, may not receive and rely upon certain types of taxability guidance from the Comptroller. In keeping with the Comptroller's goals of fair and

[1] Hereinafter, all references to "Rule" or "Rules" (as appropriate) are to Chapter 34 of the Texas Administrative Code.

efficient tax administration, we recommend that the Comptroller's office consider making a few modifications and clarifications to Proposed Rule § 3.1 as discussed below.

First, as a general matter, Proposed Rule § 3.1(c) indicates some uncertainty as to the reliance upon general information letters wherein the Comptroller may direct the requestor to relevant authorities that often may have broad applicability. We suggest that the Comptroller's office consider clarifying the extent to which a taxpayer may rely upon general information letters that are issued and/or published by the Comptroller. In particular, we suggest that the Comptroller's office consider providing that taxpayers who follow such written guidance should receive a waiver of interest and penalty, or at a minimum a waiver of penalty, if the guidance should later be rejected. A policy that provides substantially more reliability for a private letter ruling than for a general information letter may be confusing to taxpayers. In addition, taxpayers who receive such published guidance and are subsequently penalized for doing so may feel that they have been treated in an unfair manner. Furthermore, a policy that provides no interest and/or penalty relief if the Comptroller' office later changes its approach might also encourage taxpayers who seek reliable guidance to request more detailed and time-consuming private letter rulings instead of more general advice. This would add to the administrative burden of Comptroller personnel. Accordingly, we suggest that the Comptroller's office consider clarifying the extent to which taxpayers may rely on written general information letters issued by the Comptroller or Comptroller personnel.

Most of our comments and suggestions with respect to Proposed Rule § 3.1 relate to the required documentation to request a private letter ruling. Section 3.1(c)(1) provides the various requirements of a valid request for a private letter ruling. Proposed Rule § 3.1(c)(1)(A) includes the requirement that the request for a private letter ruling must contain certain "identifying information for the person or entity to which the ruling request relates"; that a "reporting entity of a combined group may request a private letter ruling related to franchise tax reporting on behalf of the combined group"; that the request "must include identifying information for all members of the combined group that are parties to the transaction"; and that if the "request does not contain the required identifying information, the comptroller will still consider the request," but no detrimental reliance will be provided unless the identity of the requestor is revealed. Separately, Proposed Rule § 3.1(c)(1)(I) requires the "signature of the person making the request," "signature of an authorized representative of the person making the request," or "signature of a third party authorized to represent the person before the Comptroller, accompanied by a power of attorney." As the information in subsection (c)(1)(I) seems likely to identify the requestor, we recommend that the Comptroller's office consider moving the information requested in subsection (c)(1)(I) to be included in the list of "identifying information" in subsection (c)(1)(A). The purpose for doing so is to enable the Comptroller's office to still consider the request for possible ruling even if the required identifying information is not contained in the ruling request.

With respect to combined group ruling requests, we suggest that the Comptroller's office consider clarifying and modifying the language of Proposed Rule § 3.1(c)(1)(A) to require "identifying information for the person, entity or combined group to which the ruling request relates..." and to state that "[t]he reporting entity of a combined group may request a private letter ruling related to franchise reporting on behalf of a combined group by including the identification of each member that seeks to rely on the ruling and identifying all members of the combined group that are parties to any transactions described in the ruling request." The failure to list one member of a combined group should not invalidate a ruling if the existence of an additional member that is part of the group is not germane to the ruling request. This is particularly relevant since the membership of a combined group may vary over time based on various facts and circumstances that indicate the existence of a unitary business.

We suggest the Comptroller's office consider modifying the language of Proposed Rule § 3.1(d)(3)(A) to delete the reference to "policies" as the Rule related to changes of policy is separately covered by subsection (e)(1). Changes in laws or rules otherwise covered in subsection (d)(3)(A) require and provide public notice through a statutorily-required process. We suggest the Comptroller's office consider modifying the Proposed Rule to specify that taxpayers who receive a private letter ruling should be notified in advance and have the opportunity to respond before a change in policy alone prospectively alters the reliability of the taxpayer's ruling. We further suggest the Comptroller's office clarify Rule § 3.1(e)(1) to provide that any revocation or modification shall not be effective with respect to the requestor until the Comptroller provides written notice of the change "to the requestor and each member of a combined group identified in subsection (c)(1)(A) or to a representative identified in writing by the requestor or combined group."

For the reasons discussed above, we respectfully request that the Comptroller's office consider modifying the currently Proposed Rule § 3.1 as indicated.

IV. PROPOSED RULE § 3.10 COMMENTS

The preamble explanation states that the revised provisions of Proposed Rule § 3.10 restate the purposes of having a taxpayer bill of rights, explain the Comptroller's longstanding policy regarding detrimental reliance, and clarify that the rights and responsibilities of the ombudsman have not been merged with those of the statutorily-required position of customer relations representative.

As a general matter, Proposed Rule § 3.10 is unclear as to whether taxpayers may rely on written guidance related to all taxes. This is particularly the case with regard to whether taxpayers who received private letter rulings may rely on those rulings, at least with respect to waiver of interest and penalty. We suggest that the Comptroller's office consider whether the four-part test of Proposed Rule § 3.10(c)(1) should apply equally to all types of taxes. More specifically where a taxpayer proves avoidable harm was incurred from the reliance on the Comptroller's written and informed advice, we suggest the Comptroller's office consider it proper that the taxpayer should receive relief from otherwise avoidable taxes, interest and/or penalties. In particular, we recommend the Comptroller's office consider revising the preamble describing Subsection (c) to clarify that the test to qualify for detrimental reliance in Proposed Rule § 3.10(c)(1) applies to all taxpayers for all taxes administered by the Comptroller. We suggest the Comptroller's office consider this modification, even though proof of avoidable harm may be very unusual in certain contexts, such as with regard to franchise taxes.

Further with respect to the text of Proposed Rule § 3.10(c), we recommend that the Comptroller's office consider clarifying the language to describe whether a taxpayer may rely upon informed and written advice and to receive an abatement of interest and/or penalties. To

Back to Table of Contents

clarify the language of the four-part test in Proposed Rule § 3.10(c)(1), we suggest the Comptroller's office consider modifying the language of Subsections (A) and (C) to read:

> (A) the substance of the information or advice and its direct communication to the taxpayer must be in writing in accordance with § 3.1 of this title;
>
> . . .
>
> (C) the taxpayer gave sufficient information to have resulted in correct advice and did not misrepresent information or withhold or conceal information that would affect the advice; and

We suggest that the Comptroller's office consider modifying Proposed Rule § 3.10(c)(3) to specify, "The following persons *will* receive waivers of [tax, penalty, and/or interest if the relevant elements are proven]" and consider modifying the second sentence of Proposed Rule § 3.10(c)(4) to provide, "If a taxpayer proves detrimental reliance in relation to the taxpayer, fees, and charges administered by the comptroller other than those identified in paragraphs (2) and (3) of this subsection, the comptroller *will consider a waiver of tax, penalty, and/or interest* for the period(s) covered by the report, audit, or assessment."

With respect to the provisions that explain the voluntary disclosure program, we suggest the Comptroller's office consider modifying the first sentence of Proposed Rule § 3.10(e)(1) to revise the introductory phrase to say, "Taxpayers who *are not currently under audit* and who come forward voluntarily to disclose their liability and pay taxes due may be eligible to have penalties and interest waived by entering into a Voluntary Disclosure Agreement." It is our understanding and experience that taxpayers who disclose under-reporting have been and are encouraged to voluntarily disclose their liability even if they were previously subject to an audit.

With respect to taxpayers' rights to have the Comptroller's tax policy division involved in disputes and discussions about taxability issues, we suggest that the Comptroller's office consider requiring Comptroller staff to include taxpayers in their requests to involve tax policy in order to streamline communications with that division. We suggest the Comptroller's office consider modifying Proposed Rule § 3.10(e)(5) by adding the following sentence to the end of that provision: "Additionally, when a member of the Comptroller's staff requests that staff from the Tax Policy Division be included in disputes and discussions about taxability issues, the staff member making such request will notify the taxpayer or taxpayer's representative of the request. Taxpayers have the right to know the positions and characterizations being communicated to the Tax Policy Division by Comptroller staff and to supplement or dispute such positions or characterizations."

We have a few additional comments concerning potential clarifications that may be helpful. The Comptroller's office may want to consider clarifying Proposed Rule § 3.10(a)(1) to say, "Various state and federal laws governing the comptroller's and taxpayers' responsibilities concerning the collection and payment of taxes and fees are addressed in other sections of this title." The Comptroller's office may also want to consider clarifying the second sentence of

Proposed Rule § 3.10(d)(1) to provide, "The customer service liaison has the authority to determine if the complaint is valid and *to work with staff to reach a resolution* . . . ."

For the reasons discussed above, we respectfully request that the Comptroller's office consider modifying the currently Proposed Rule § 3.10 as discussed above.

V. CONCLUSION

We greatly appreciate the opportunity to work with your office on these significant tax issues and hope that these comments are helpful to you as you craft final rules relating to the letter ruling process and the Taxpayer Bill of Rights. Thank you for your consideration.

Back to Table of Contents

SECTION OF TAXATION
State Bar of Texas

August 23, 2012

via email to bryant.lomax@cpa.state.tx.us

Mr. Bryant Lomax
Texas Comptroller of Public Accounts
Manager, Tax Policy Division
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Austin, Texas 78711-3528

RE: **Response to Comptroller Request for Comments Concerning Proposed Amendments to Rule 3.325**

Dear Mr. Lomax:

On behalf of the Section of Taxation of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Texas Comptroller of Public Accounts for comments pertaining to proposed amendments to Comptroller Rule 3.325.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE SECTION OF TAXATION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE SECTION OF TAXATION, WHICH HAS SUBMITTED THIS LETTER, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW. THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENTAL SUBMISSIONS OF THE STATE BAR OF TEXAS SECTION OF TAXATION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE SECTION OF TAXATION MEMBERS WHO PREPARED THEM.

Back to Table of Contents

We greatly appreciate the opportunity to work with your office on these significant tax issues and hope to provide relevant analysis for your review. Thank you for your consideration.

Respectfully submitted,

Tina R. Green
Chair, Section of Taxation
The State Bar of Texas

Back to Table of Contents

RESPONSE TO REQUEST FOR COMMENTS REGARDING PROPOSED AMENDMENTS TO COMPTROLLER RULE 3.325

This response to request for comments with respect to proposed amendments to Comptroller Rule 3.325 is presented on behalf of the Section of Taxation of the State Bar of Texas (the "Section"). The principal drafters of these comments are the Chair and Vice Chairs of the Section's Committee on State and Local Taxation: Ira Lipstet, Charolette Noel, Sam Megally and Matt Hunsaker. The Section's Committee on Government Submissions ("COGS") has approved these comments. Stephanie Schroepfer is the Chair of COGS and Alyson Outenreath, officer of the Section reviewed this response to request for comments on behalf of COGS.

Although many of the persons who participated in preparing this letter have clients who would be affected by the state tax principles addressed by this letter or have advised clients on the application of such principles, no such person (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of this letter.

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Date: August 23, 2012

I. EXECUTIVE SUMMARY

This comment letter is in response to the request of the Texas Comptroller of Public Accounts (the "Comptroller") for comments concerning proposed amendments to 34 Tex. Admin. Code § 3.325 relating to practices and procedures concerning refunds and payments under protest ("Proposed Rule § 3.325).[1]

II. INTRODUCTION

We recognize and appreciate the challenges facing the Comptroller when balancing the task of providing a fair and transparent administrative process for responding to refund claims and resolving taxpayer disputes against the Comptroller's need for an efficient administrative process to resolve such claims and controversies. It is our intent to present items for consideration that may help and support Comptroller personnel.

The focus of these comments is on the modification and/or addition of Rule provisions that dictate what type of documentation will be considered sufficient to support a valid claim for refund. A corresponding consideration is that failure to provide what is considered to be necessary or sufficient documentation will result in the statute of limitations for the administrative process not being tolled. Because failure to toll the statute of limitations can be fatal to a refund claim it is important that any such Rule provisions be both extremely clear as to interpretation as well as reasonable with respect to the ability of the claimant to comply with the Rule requirements. Following are comments and suggestions addressing several of these issues.

III. PROPOSED RULE § 3.325 COMMENTS

The Comptroller's office has proposed amending current Rule § 3.325 concerning refunds and payments under protest in several respects including with respect to: 1) the establishment of policy with respect to third parties to whom permitted sellers may assign a right to refund; 2) the identification of types of documents that are needed by the Comptroller to verify claims; and 3) the identification of items that must be submitted with a refund claim in order to toll the statute of limitations in connection with the claim, as well as instances where such requirements are not met and the statute of limitations will not be tolled.

The proposed changes would include modifications to Rule § 3.325(a)(4)(E) providing that supporting documentation for verification of any refund claim or credit taken must include "copies of invoices, cancelled checks, and executed contracts." We note that not every claim will be of a type such that those specific types of documentation exist, but may well still be a valid claim. We suggest that the Comptroller's office consider adding language clarifying such documentation is to be included "as appropriate."

A further proposed modification to Rule § 3.325(a)(4)(E) contains language specifying that if supporting documentation cannot be easily mailed or otherwise easily submitted to the agency, the refund claim must include a statement that all supporting documentation necessary to verify the claim will be made available to the Comptroller upon request. Indicating that difficult

[1] Hereinafter, all references to "Rule" or "Rules" (as appropriate) are to Chapter 34 of the Texas Administrative Code.

to deliver documentation will be made available by claimant upon Comptroller request is certainly reasonable. The language as drafted, however, could give rise to an interpretation that any supporting documentation that is not available at the moment when the refund claim is submitted will not, if subsequently obtained, be considered in support of the claim. We suggest that the Comptroller's office consider adding language clarifying that documentation obtained or located subsequent to the initial filing of the refund claim will be provided to the Comptroller as it becomes available so long as it is within the specified period during which such documentation may be provided.

New subsection (b)(10) is proposed to be added to existing Rule § 3.325. Proposed subsection (b)(10) specifies requirements that need to be met in order to toll the statute of limitations with respect to a refund claim. There may be a significant amount of time that elapses between filing a refund claim and a determination of the Comptroller's position with respect to the claim. Submitting a claim and learning only at some later date that the Comptroller considers the initial claim to be inadequate would be an extremely adverse result for the claimant if the statute of limitations to modify the claim had expired in the interim. Currently proposed draft language and potential modifications to certain proposed changes are as follows.

Proposed Rule § 3.325(b)(10)(A)(i) specifies that "the claim states fully and in detail each reason or ground on which the claim is founded, as required by subsection (a)(4)(A) of this section." Rule § 3.325(a)(4)(A) (as proposed to be modified) requires that a person who requests a refund from the Comptroller must submit a claim in writing that states fully and in detail each reason or ground on which the claim is founded. Setting out in sufficient detail the bases for a refund claim such that the Comptroller is adequately apprised of the nature of the claim is certainly reasonable and appropriate. A literal reading of the proposed modification, to "state fully and in detail each reason or ground on which the claim is founded," could lead to a construction that if any reason at all upon which the claim **could** be based is not included in the refund submission, the statute of limitations **would not** be tolled even if there are sufficient other grounds to sustain a refund.

We suggest the Comptroller's office consider modifying the language of Proposed Rule § 3.325(b)(10(A)(i) to specify that "the claim must state fully and in sufficient detail the reason or ground on which the claim is founded." We further suggest that Rule § 3.325(a)(4)(A) be modified to specify that "A person who requests a refund from the comptroller must (A) submit a claim in writing that states fully and in sufficient detail the reason or ground on which the claim is founded."

Proposed Rule § 3.325(b)(10)(A)(iii) specifies that " if the claim is being filed by a non-permitted person who is an assignee of or successor to a refund that may be owed, the person submits with the claim for refund the assignment of right to refund." This proposed language could be interpreted to mean that if an assignment of the right to refund is not submitted with the initial refund claim, the statute of limitations will not be tolled irrespective of when the assignment of the right to refund is provided to the Comptroller by claimant. We suggest that the Comptroller's office consider modifying the language of Proposed Rule § 3.325(b)(10)(A)(iii) to read "if the claim is being filed by a non-permitted person who is an assignee or successor to a refund that may be owed, the person submits with the claim**, or timely**

provides thereafter (but in no event later than the time specified for providing evidence pursuant to Tex. Tax Code § 111.105(e)), the assignment of right to refund."

Proposed Rule § 3.325(b)(10)(A)(iv) specifies that the statute of limitations will be tolled "if a person other than the person to whom the refund is due is submitting the claim for refund, a power of attorney is submitted with the claim." This proposed language could be interpreted to mean that if a power of attorney is not submitted with the initial refund claim, the statute of limitations will not be tolled irrespective of when the power of attorney is provided to the Comptroller. We suggest that the Comptroller's office consider modifying the language of proposed Rule § 3.325(b)(10)(A)(iv) to read "if a person other than the person to whom the refund is due is submitting the claim for refund, a power of attorney is submitted with the claim, **or such power is timely provided thereafter (but in no event later than the time specified for providing evidence pursuant to Tex. Tax Code § 111.105(e)."**

For the reasons discussed above, we respectfully request that the Comptroller's office consider modifying the currently Proposed Rule § 3.325 as discussed above.

IV. CONCLUSION

We greatly appreciate the opportunity to work with your office on these significant tax issues and hope that these comments are helpful to you as you craft final rules relating to practices and procedures concerning refunds and payments under protest. Thank you for your consideration.

Back to Table of Contents

THE CARRIED INTEREST DEBATE: STOP SPLITTING HAIRS AND START SPLITTING BABIES

May 1, 2012

Back to Table of Contents

THE CARRIED INTEREST DEBATE: STOP SPLITTING HAIRS AND START SPLITTING BABIES

May 1, 2012

Introduction				1
I.	The Taxation of Private Equity Fund Managers under Current Law			3
	A.	The Structure of Private Equity Funds and the Compensation of Fund Managers		3
		1.	Typical Private Equity Fund Structure	4
		2.	Industry Standard Compensation of Fund Managers – Two and Twenty	6
			a. The Two	6
			b. The Twenty	7
	B.	How Current Law Permits Fund Managers to Defer Carried Interest Income and Pay Taxes at Capital Gains Rates		8
		1.	Deferral of Income	9
		2.	Character of Income	11
	C.	Illustration		14
II.	The Capital vs. Compensation Debate			15
	A.	Argument that Carried Interest Income is Fundamentally Compensation for Services		16
	B.	Argument that Carried Interest Income is Appropriately Treated as Capital		18
	C.	Argument that Carried Interest Income Consists of Both Capital and Labor Components		19
		1.	Insufficiency of the Performance-Based Compensation Analogy	19
		2.	Insufficiency of the Sweat Equity Analogy	21
		3.	Carried Interest Income as an Aggregate of Capital Gain and Compensation	22
III.	Evaluation of Legislative and Academic Proposals to Reform the Taxation of Income from Carried Interests			24
	A.	Proposed Section 710 – Treating a Predetermined Portion of Carried Interest Income as Ordinary upon Realization		27
		1.	Description	27
		2.	Illustration	28
		3.	Analysis	29
	B.	Approximating the Labor Component of Carried Interest Income through a Cost-of-Capital Approach		31
		1.	Description	31
		2.	Illustration	33
		3.	Analysis	35
IV.	Splitting the Baby - Proposed Aggregate Cost-of-Capital Bifurcation with Augmented Interest Rate Based Imputation of Compensation			39
	A.	Proposal		39
	B.	Illustration		43
Conclusion				45

INTRODUCTION

When equals are not taxed equally, the principle of horizontal equity is offended,[1] and the resultant populist indignation ought to be anticipated. It is against this backdrop that the advantageous capital gain tax treatment of the generous compensation of private equity[2] fund managers has been the target of persistent scrutiny in recent years from legislators,[3] the executive branch,[4] and the media at large.[5]

Although Professor Victor Fleischer sounded the first whistle in 2006,[6] prompting a slew of academic and legislative proposals to address the ostensibly insupportable capital gain treatment of fund managers' carried interest income, reform has proved elusive.[7] One might expect that the emergence of former private equity fund manager, Mitt Romney,[8] as a credible candidate for the presidency might inject renewed vigor into the carried interest debate,

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[1] Joseph T. Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REV. 567, 574 (1965).

[2] Though the taxation of carried interests implicates a variety of investment funds, including oil and gas, real estate, and hedge funds, this article analyzes the issue solely in the context of private equity, as this is the vehicle through which current tax law provides the most latitude for fund managers to take advantage of opportunities to defer income from their labor and achieve beneficial capital gain treatment. *See* Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 9-15 (2008).

[3] *See, e.g.*, Joint Comm. on Taxation, Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part I, JCX-62-07 (September 4, 2007), available at http://www.house.gov/jct/x-62-07.pdf; Carried Interest, Part I: Hearing before the S. Comm. on Finance, 110th Cong. (July 11, 2007), available at http://finance.senate.gov/hearings/hearing/ ?id=e1a96355-ae4d-8c00-dd88-9b3ccc679e8f.

[4] *See* Joint Comm. on Taxation, Description of Revenue Provisions Contained in the President's Fiscal Year 2012 Budget Proposal, JCS-3-11 (June, 2011), available at http://www.jct.gov/ publications.html?func=startdown&id=3796 (outlining President Obama's proposal to change present law to treat income from partnership profits interests to partners performing services as ordinary).

[5] *See, e.g.*, Nicholas D. Kristof, *Taxes and Billionaires*, N.Y. TIMES, July 7, 2011, at A23 (arguing that current treatment of carried interests in private equity amounts to an undeserved tax loophole); *but see* Steve Forbes, *Private Equity, Public Benefits*, WALL ST. J., July 25, 2007, at A14 (arguing that abandoning current treatment of carried interests would result in severe negative externalities due to the restriction of access to vital capital for companies who cannot avail themselves of conventional financing alternatives).

[6] Fleischer, *supra* note 2 (initial publication as Univ. of Colo. Law School Legal Studies Research Paper No. 06-27 (2006)).

[7] Howard E. Abrams, *Taxation of Carried Interests: The Reform that did not Happen*, 40 LOY. U. CHI. L. J. 197, 197-98 (2009) (noting that "changing the taxation of carried interests as suggested by its critics is far more difficult than claimed").

[8] See Todd Hixon, *An Insider Perspective on Carried Interest*, FORBES (February 2, 2012), available at http://www.forbes.com/sites/toddhixon/2012/02/02/an-insider-perspective-on-carried-interest/ (commenting that the release of Mitt Romney's personal income tax returns, detailing an effective tax rate of fourteen percent on $25 Million in income due to partnership profits interests he earned as an investment fund manager at Bain Capital, will "put carried interest in the spotlight").

potentially culminating in a restructuring that would sate the public appetite for distributive justice.[9] Time will tell.

Certainly there are bigger fish to fry than private equity fund managers' carried interest income. With proposed reform expected to generate a paltry annual revenue increase of roughly $3 billion,[10] critics will justifiably argue that the focus of tax overhaul should be more comprehensive, given the current state of affairs.[11] Still, at a time when the top one percent of American households hold more wealth than the entire bottom ninety percent,[12] carried interest reform is low-hanging fruit for politicians seeking to capitalize on populist class rivalry.

While the pitch of political pomposity in the carried interest debate is a convenient tuning fork to approximate the timing and ultimate shape of consequent tax reform, this article does not discuss the political necessities or consequences entailed.[13] Rather, this article seeks to identify the conceptual middle ground between the status quo of capital gain treatment of carried interests and the argument for total conversion to ordinary income treatment, rejecting the false dichotomy that dominates much of this debate.[14]

First, however, this article presents a brief overview of the taxation of private equity fund managers under current law.[15] This article then proceeds to analyze a sample of legislative and academic proposals and evaluates their respective commensurability with the position that

[9] *See* Fleischer, *supra* note 2, at 5.
[10] Michael S. Knoll, *The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of Taxing Profit Interests as Ordinary Income*, 50 WM. & MARY L. REV. 115, 139 (2008) (examining the present value annual revenue increase that could be realized through treating carried interest income as ordinary rather than capital).
[11] *See* Cong. Budget Office, Updated Budget Projections: Fiscal Years 2012 to 2022 (March, 2012) (predicting a budget deficit of $1.171 trillion for fiscal year 2012, with continued deficits for the foreseeable future).
[12] Michael R. Pieczonka, *The Largest Loophole in Federal Tax Law: Preferential Capital Gain Treatment for Private Equity and Hedge Fund Managers' Carried Interests*, 42 J. MARSHALL L. REV. 529, 529-30 (2009).
[13] This is not to suggest that this tax policy article is entirely apolitical. *See* Sheldon D. Pollack, *Tax Reform: The 1980's Perspective*, 46 TAX L. REV. 489, 491 (1991) ("Tax reformism is political by nature precisely because any change (whether designated by reform or otherwise) to existing political institutions and extant legal structures has distinct political implications. The adoption of any significant change to the tax law constitutes a political act. Indeed the very decision to adopt an income tax is a political decision of the highest order.").
[14] *See infra*, Section II.
[15] *See infra*, Section I.

Back to Table of Contents

income from carried interests includes both capital and ordinary components.[16] Ultimately, this article proposes a modified version of the cost-of-capital approach, first advanced by Professor Fleischer,[17] as a workable reform proposal to split the baby, appropriately taxing both the labor and capital components of carried interest income.[18]

I. THE TAXATION OF PRIVATE EQUITY FUND MANAGERS UNDER CURRENT LAW

This section describes the current situation with respect to the taxation of private equity fund managers' carried interest income. In the interest of brevity, a basic description of a typical domestic[19] private equity fund structure is provided.[20] Next, this section provides an overview of the standard compensation regime for private equity fund managers, including an introduction of the carried interest. Lastly, this section includes an explanation of the tax treatment of fund managers' compensation under current law and illustrates this by way of example.

A. The Structure of Private Equity Funds and the Compensation of Fund Managers

Private equity funds are a subspecies of investment fund that typically invest in privately held business organizations and, in the process, restructure the companies' capitalization, management, and organization.[21] Private equity fund investments can take the form of growth capital, mezzanine financing, buyouts, or recapitalization funds, each of which entails (at least in

[16] *See infra*, Section III.
[17] Fleischer, *supra* note 2, at 52-54.
[18] *See infra*, Section IV.
[19] *See* Samuel D. Brunson, *Taxing Investment Fund Managers Using a Simplified Mark-to-Market Approach*, 45 WAKE FOREST L. REV. 79, 83, n. 26 (2010) (noting that offshore investment funds present their own distinct taxation issues, but because they are not typically organized as partnerships, the question of pass-through capital gain treatment of their managers' compensation is not generally implicated). The scope of this article is limited to domestic private equity funds. For reading on the tax treatment of offshore investment funds, *see* Lynnley Browning, *A Hamptons for Hedge Funds: Offshore Tax Breaks Lure Money Managers*, N.Y. TIMES (July 1, 2007), available at http: //www.nytimes.com/2007/07/01/business/yourmoney/01cay.html?pagewanted=all.
[20] For a more comprehensive description of the structural alternatives for private equity funds, *see generally* Ulf Axelson et al., *Why are Buyouts Levered? The Financial Structure of Private Equity Funds*, SWEDISH INST. FOR FIN. RESEARCH, Research Report No. 49 (February, 2008), available at http://www.pegcc.org/wordpress/wp-content/uploads/why-are-buyouts-levered.pdf.
[21] Joint Comm. on Taxation, *supra* note 3, at 16.

part) an acquisition of equity in closely held business organizations in exchange for the provision of capital.[22]

1. Typical Private Equity Fund Structure

Private equity funds are most commonly organized as limited partnerships.[23] The primary source of capital for private equity funds comes from institutional, tax-exempt investors, such as pension funds, education funds, endowments, and charitable funds.[24] These investors comprise the limited partners (LPs) of the private equity fund.[25] In exchange for their investment, the LPs receive a capital interest in the fund partnership commensurate with the amount of their capital contribution.[26]

A fund manager business entity, usually organized under state law as a limited liability company, or similar business organization that provides pass-through taxation to its owners, serves as the general partner (GP) of the fund.[27] The individual fund managers can also serve directly as general partners in the typical private equity fund structure, without the use of a fund manager entity, but this is less common.[28] The GP generally contributes a comparatively small amount of capital to the fund, ranging from one to five percent of the total initial investment.[29] In addition, the GP provides services to the fund in the form of investment expertise in selecting target companies as portfolio assets, negotiating and executing the terms of investment in these companies, managing these investments, representing the fund's interests vis a vis the portfolio companies, and designing and executing exit strategies to dispose of such investments.[30]

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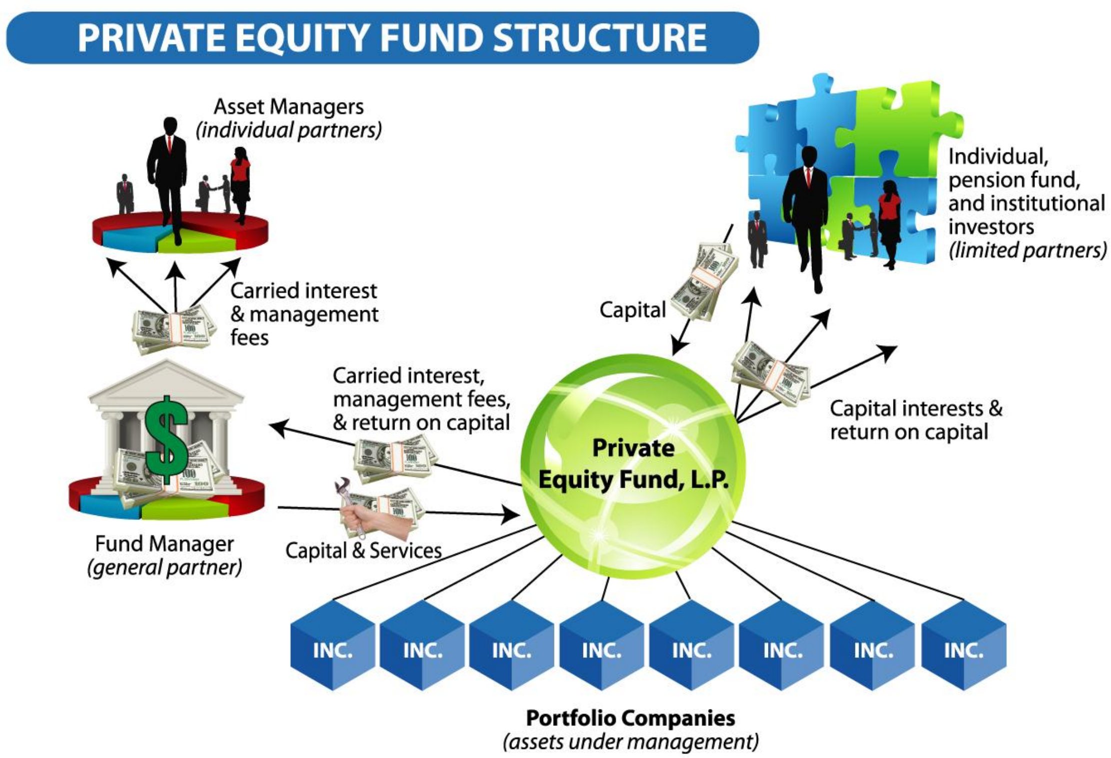
[22] *Id*., at 16-17.
[23] Brunson, *supra* note 19, at 84.
[24] Joint Comm. on Taxation, *supra* note 3, at 2.
[25] *Id*.
[26] Abrams, *supra* note 7, at 200.
[27] Fleischer, *supra* note 2, at 8.
[28] *See* Joint Comm. on Taxation, *supra* note 3, at 2.
[29] Fleischer, *supra* note 2, at 8.
[30] Joint Comm. on Taxation, *supra* note 3, at 2-3.

Back to Table of Contents

Under the management of the GP, the private equity fund deploys its capital through debt, equity, or hybrid investments in privately held companies.[31] It is through the appreciation in the value of these investments that the fund will grow and generate income for the LPs and the GP. The GP retains plenary authority over the acquisition and disposition of fund investments.[32]

Figure 1 below is a graphical illustration of the typical private equity fund structure, including the flow of investment and returns, which are described in the following sub-section.

Figure 1[33]



[31] *See* Knoll, *supra* note 10, at 121 (Private equity funds can be divided into two main subcategories: buyout funds which generally take substantial equity positions in established companies and provide debt and/or equity capital to restructure and improve their performance, and venture capital funds, which make early stage equity investments in start-up companies with promising upside potential).
[32] *Id*.
[33] Figure 1 is an original adaptation of a similar figure depicted in Joint Comm. on Taxation, *supra* note 3, at 2, supplemented with additional detail and original illustration. Illustration prepared by Mr. James Borne, independent media and graphic artist residing in Houston, Texas.

2. Industry Standard Compensation of Fund Managers – Two and Twenty

The quasi-mythical origins of the standard "two and twenty" compensation package for private equity firms are often the subject of mockery.[34] While this mystique provides some measure of support to the wizard behind the curtain allusion often ascribed to fund managers, some gratitude is in order, as it renders the present description broadly applicable.[35]

In addition to being entitled to a return on its capital investment in the fund (if any), the GP usually receives both an annual management fee and a profits interest in the fund.[36] If the pun will be pardoned, the two and twenty compensation scheme permits a private equity firm to "hedge" its bets by bifurcating its remuneration into one stream of income that is steady and predictable and another that is speculative, but potentially very lucrative.

a. The Two

A typical private equity fund partnership agreement provides for an annual management fee of two percent of the fund's committed capital to be paid from the fund to the GP.[37] The management fee is disbursed to the GP annually or quarterly,[38] and the individual fund managers recognize ordinary income[39] in proportion to their respective ownership interests in the GP.[40] As

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[34] *See* Fleischer, supra note 2, at 3 ("It's like Moses brought down a third tablet from the Mount – and it said '2 and 20'") (quoting Neil Weinberg and Nathan Vardi, *Private Inequity*, FORBES (Mar. 13, 2006) (quoting Christopher Ailman, Chief Investment Officer, California State Teachers' Retirement System)).

[35] It should be noted that every fund's partnership agreement may govern the allocation of income, expenses, and sales proceeds on dispositions of portfolio assets in a unique way, though the industry standard of a two percent management fee and a twenty percent carried interest is the recognized "tradition" of the industry. *See* Christopher W. Livingston, *Finding the Right Balance: A Critical Analysis of the Major Proposals to Reform the Taxation of Carried Interests in Private Equity*, 62 TAX LAW. 241, 244-45 (2008).

[36] *See* Knoll, *supra* note 10, at 123; *see also* David A. Weisbach, *The Taxation of Carried Interests in Private Equity*, 94 VA. L. REV. 715, 722-23 (2008) (noting that fund managers also typically receive "transaction fees" for services rendered to portfolio companies, such as serving as a director or providing consulting services). This additional source of income is outside the scope of the present article.

[37] Weisbach, *supra* note 36, at 722.

[38] *See Id*. (It is often the case that the management fee obligation is limited in duration, such as the first five years of the fund, reflecting "the fact that the [GP] will be performing more intensive services during this period").

[39] *See* Noel B. Cunningham and Mitchell L. Engler, *The Carried Interest Controversy: Let's not get Carried Away*, 61 TAX L. REV. 121, 123 (2008) (noting that there is no debate as to the ordinary character of the management fee

Back to Table of Contents

ordinary income, the management fee is subject to taxation in the current period,[41] up to a maximum rate of thirty-five percent.[42]

b. The Twenty

In addition to the annual management fee, private equity fund partnership agreements generally provide for the GP to participate in the upside potential of the fund in the form of a partnership profits interest.[43] This entails that the GP receive "a right to receive a percentage of fund profits without an obligation to contribute a corresponding share of the financial capital of the fund."[44] The industry standard compensation package allocates a twenty percent share of the fund's future profits to the GP.[45] The profits interest is also known by equivalent nomenclature, such as "promote," "carry," or "carried interest."[46] For the sake of consistency, this article will use the term "carried interest."

Often times, the fund partnership agreement will provide that the LPs are entitled to primacy in the allocation of fund profits. For instance, the LPs frequently receive return on their capital plus a specified amount of profits before the GP is entitled to a share of fund profits.[47] A common threshold (the "hurdle rate") under these arrangements is the first eight percent of fund

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income); *but see* Fleischer, *supra* note 2, at 23 (describing a planning strategy whereby private equity fund managers can electively reduce the management fee "in exchange for a larger allocation of fund profits," possibly resulting in deferral of recognition and ultimate capital gain treatment). This article analyzes the taxation of private equity fund managers using a simple "two and twenty" compensation scheme and does not discuss the implications of such strategies.

[40] I.R.C. § 702(b) ("The character of any item of income […] included in a partner's distributive share […] shall be determined as if such item were realized directly from the source from which realized by the partnership").

[41] I.R.C. § 61(a)(1) (gross income includes fees).

[42] I.R.C. § 1(a), (i) (providing that gross income in excess of $125,000 for single taxpayers and $250,000 for married taxpayers filing jointly be taxed at a rate of 35% for the current year, 2012).

[43] Fleischer, *supra* note 2, at 3.

[44] Marguerite Racher Snyder, *Recasting Carried Interest: An Examination of Recent Tax Reform Proposals*, 84 IND. L. J. 1449, 1453 (2009).

[45] Shrilaxmi S. Satyanarayana, *Tax Equality: Eliminating the Low Effective Marginal Tax Rates for Private Equity Professionals*, 82 ST. JOHN'S L. REV. 1589, 1591 (2008).

[46] *See* Fleischer, *supra* note 2, at 3.

[47] Weisbach, *supra* note 36, at 722.

profits.[48] The typical scheme will provide that the LPs receive the first eight percent of fund profits, the GP will receive the next two percent, and the LPs and GP will be entitled to eighty and twenty percent respectively of fund profits beyond the first ten percent.[49] Such hurdle rate arrangements magnify the GP's upside incentive and further align the economic interests of the GP with those of the LPs.[50]

The carried interest represents a remarkable incentive for the GP, as the potential for substantial return is tied to the shrewdness of its fund management decisions.[51] Moreover, due to the typically lean staff of investment professionals in most private equity firms, "a carried interest worth millions of dollars may be split among just a handful of individuals."[52] The following sub-section discusses current law's tax treatment of carried interest income.

B. How Current Law Permits Fund Managers to Defer Carried Interest Income and Pay Taxes at Capital Gains Rates

Under current law, prudent planning can enable private equity fund managers to defer recognition of income from carried interests and to recognize such income as capital gains upon realization.[53] The preferential treatment for carried interest income is a function of: 1) the general principle of partnership taxation, which provides that items of income retain their partnership-level character upon allocation to each individual partner;[54] and 2) the capital gain preference,

[48] *Id*.
[49] *Id*. (explaining that the traditional 80/20 split is preserved in the hurdle rate arrangement, but that the specific profits to which each group is entitled is augmented. It is argued that a hurdle rate arrangement introduces an added risk element to carried interest income that would counsel continued capital gains treatment). This article does not discuss the implications of hurdle rates.
[50] *Id*.
[51] Fleischer, *supra* note 2, at 9.
[52] *Id*.; *but see* Weisbach, *supra* note 36, at 723 (commenting that, despite the tremendous upside potential presented by carried interests, industry studies reveal that "roughly two-thirds of the payments to the [GP] are from management or transaction fees and, correspondingly, roughly one-third is from the carried interest") (citing earlier draft of Andrew Metrick and Ayako Yasuda, *The Economics of Private Equity Funds*, SOC. FOR FIN. STUDIES (April 22, 2010), available at http://www.stanford.edu/~piazzesi/Reading/MetrickYasuda2010.pdf).
[53] Fleischer, *supra* note 2, at 10.
[54] I.R.C. § 702(b).

pursuant to which income from the appreciation of investments may be deferred until transfer of the investment and long-term capital gains are subject to taxation at a rate of fifteen percent, as opposed to ordinary income, which is taxed at graduated rates up to a maximum of thirty-five percent.[55] The following is an explanation of how fund managers are able to exploit current law to take advantage of the capital gain preference, resulting in substantial tax advantages.

1. Deferral of Income

A carried interest is inarguably an item of value that is granted to the GP upon execution of the fund partnership agreement in exchange for services rendered or to be rendered to the fund partnership.[56] Intuition would counsel that, under normal circumstances, such an event would be taxable.[57] However, due to their indefinite present value, carried interests are not subject to tax upon receipt.[58] Despite being a piece of property that has the potential to be worth millions of dollars,[59] the "fair market value [of a carried interest] is difficult to pin down at the time of grant because [it] is typically non-transferrable, highly speculative, and dependent on the efforts of the [fund managers] themselves."[60]

The Internal Revenue Code contains no express provisions related to the receipt of a carried interest in exchange for services.[61] However, case law and revenue procedures confirm

[55] Fleischer, *supra* note 2, at 14-15; I.R.C. §§ 1(h)(1)(C), 1(a), (i). It is worth noting that, without the current 20% disparity between the top marginal tax rate for ordinary income and the long-term capital gain tax rate, the carried interest preference would be significantly diminished, although not entirely eliminated due to the realization requirement. *See* Noel B. Cunningham and Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319, 365 (1993). While the prudence of the capital gain preference is outside the scope of this article, it should be noted that this article is not advocating for its elimination.

[56] *See* Note, *Taxing Partnership Profits Interests: The Carried Interest Problem*, 124 HARV. L. REV. 1773, 1777-78 (2011).

[57] I.R.C. § 61(a)(1) (income from services included in gross income); I.R.C. § 83(a) (property received in exchange for services gives rise to ordinary income in the amount of the fair market value of the property).

[58] *See* Fleischer, *supra* note 2, at 10-11.

[59] *Id*. at 10; *but see* Weisbach, *supra* note 36, at 724 (noting that private equity carried interests are highly speculative and that a significant percentage of private equity funds do not generate any payments on carried interest).

[60] Fleischer, *supra* note 2, at 10.

[61] Joint Comm. on Taxation, *supra* note 3, at 25.

that the receipt of a carried interest is generally a non-taxable event, barring circumstances that are not characteristic of private equity.[62] Because a carried interest is a profits-only partnership interest, its actual value at the time of transfer to the GP is concededly nothing, and it would be improper to ascribe some arbitrary value to the carried interest to render the transfer taxable under section 83. Even under a pure Haig-Simons regime of taxation, it would only be the appreciation of the carried interest's value during the life of the fund that would give rise to accretion that is taxable to the GP.[63] It is in the deferred recognition of the ongoing accretion that the taxation of carried interests deviates from the Haig-Simons ideal.[64]

In addition to the receipt of the carried interest being a non-taxable event, the ability to defer recognition of income on the carried interest as the fund operates provides an additional significant advantage to the GP.[65] Due to the realization requirement, the GP will not recognize gains attributable to its carried interest as they accrue, but only as the fund's investments are liquidated.[66] As discussed, the carried interest is a purely profit-bearing partnership interest. Accordingly, only an increase in the value of the fund's underlying investments in private securities will give rise to income on the carried interest to the GP. However, private securities

[62] *Id*. (citing *Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991) (concluding that partnership profits interests were not includable on receipt due to their speculative nature and lack of fair market value); Rev. Proc. 93-27, 1993-2 C.B. 343 (ruling that the receipt of a partnership profits interest for services generally is not a taxable event for the partnership or the partner, except where: 1) the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as high-quality debt securities; 2) the partner disposes of the profits interest within two years of receipt; or 3) the profits interest is a limited partnership profits interest in a publicly traded partnership)). Because private equity fund investments are typically equity positions in closely held corporations that are held for several years, the safe harbor provisions of Rev. Proc. 93-27 are generally inapplicable.
[63] *See* William D. Andrews, *Personal Deductions in an Ideal Income* Tax, 86 HARV. L. REV. 309, 320 (1972).
[64] *See* Cunningham & Schenk, *supra* note 55, at 322.
[65] Joint Comm. on Taxation, *supra* note 3, at 25 (referencing the time value of money principle that "taxes paid or saved now are worth more than taxes paid or saved later"); *see also* Weisbach, *supra* note 36, at 726 ("carried interests were commonly used even when there was no rate differential between capital gains and ordinary income") (citing Paul Gompers and Josh Lerner, *An Analysis of Compensation in the U.S. Venture Capital Partnership*, 51 J. FIN. ECON. 3 (1999)). This suggests that the value of deferral is perhaps even superior to that of the rate preference.
[66] *See* Cunningham and Schenk, *supra* note 55, at 322.

are not amenable to reliable or expedient valuation.[67] Therefore, the actual amount of income the GP earns on its carried interest during the life of a given fund investment, per Haig-Simons, is stubbornly elusive. This practical constraint is the reason the GP is not taxed on the periodic increases in the value of the carried interest.[68]

Although this pragmatic limitation is not unique to carried interests,[69] at least in the context of typical investments, the realization requirement can cut both ways – investors must also defer investment losses until realization.[70] But, because the carried interest is solely profit bearing, only a net gain has the potential to be deferred, thereby eliminating the Treasury-friendly counterweight of the realization requirement, that losses must also be deferred until realization.[71] Therefore, the same deferral principles that advantage the GP work to the detriment of the Treasury.

2. Character of Income

Due to the pass-through nature of the private equity fund partnership, the GP will recognize income to which it is entitled in the same character the income is recognized at the fund partnership level.[72] This is so because the GP is entitled to income from its carried interest in its capacity as a partner with a partnership interest – specifically, a profits interest.[73] Because the fund realizes income when it sells positions in portfolio companies in which it has invested,

[67] *Id*. at 346-47 (noting that the primary obstacle to a mark-to-market system that would tax capital accretion on an annual basis is valuation).
[68] *But see* Brunson, *supra* note 19, at 106 (advocating application of a simplified mark-to-market approach, whereby appreciation of the carried interest would be measured on the basis of the private equity fund's internal reporting to its investors and taxing the individual fund managers on their proportionate share of the carried interest appreciation each year during the fund's operation).
[69] Cunningham and Schenk, *supra* note 55, at 346-47.
[70] *Id*. at 322 (noting, however, that the primary effect of the realization requirement is to defer gains because the taxpayer is in control of the timing of realization and will tend to realize losses as they accrue and defer gains wherever possible.
[71] *See* Fleischer, *supra* note 2, at 12-13.
[72] I.R.C. § 702(b).
[73] Note, *supra* note 56, at 1780; I.R.C. § 707.

the character of the fund partnership level profits is unambiguously capital.[74] In the case of the management fee, the GP is compensated in its secondary capacity of service provider to the fund partnership, and the management fee is therefore treated as an item of ordinary income to the GP.[75]

The same partnership pass-through principle benefits the individual fund managers at the GP level. Because the GP recognizes carried interest income as a capital gain, it passes through to the individual fund managers in the same character.[76] Thus, the individual partners in the GP receive capital gains income in exchange for providing their investment management services to the fund.[77] Compensation for services of this kind would, under normal circumstances, be treated as ordinary income, but through the manipulation of partnership structures, the fund managers are able to convert the character of income from their services into capital gains.[78]

This conversion gives rise to the most facially offensive aspect of the carried interest debate.[79] Much of the scrutiny is attributable to the significant disparity between the fifteen percent tax rate on long-term capital gains[80] and the top marginal tax rate of thirty-five percent

[74] I.R.C. § 1221(a); see also I.R.C. § 1222(3) (requiring that capital assets be held for more than one year before liquidation in order to be eligible for long-term capital gain preference). This is usually the case for portfolio investments of private equity funds, which are typically held for several years. *See* Carried Interest, Part II: Hearing Before the S. Comm. on Finance, 110th Cong., 1 (July 31, 2007) (testimony of Bruce Rosenblum, Chairman of the Board of The Private Equity Council), available at http://finance.senate.gov/hearings/testimony/2007test/073107.testbr.pdf.
[75] Note, *supra* note 56, at 1780; I.R.C. § 707(a) ("If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall […] be considered as occurring between the partnership and one who is not a partner).
[76] I.R.C. § 702(b).
[77] Note, *supra* note 56, at 1780.
[78] Fleischer, *supra* note 2, at 14.
[79] *See supra*, Section I,B,1. Even though deferral can be just as advantageous (or even more so) than the applicable tax rate reduction, it is the 15% rate that raises eyebrows.
[80] I.R.C. § 1(h)(1)(C).

for ordinary income.[81] This is the aspect of carried interest taxation that strikes the populist chord of resentment and feeds the ongoing dispute.[82]

Because most private equity fund LPs are tax-exempt, there is no substitute taxpayer for the taxes avoided by the GP.[83] As a general proposition, one taxpayer's benefit usually burdens some other taxpayer.[84] But, because the LPs are tax-exempt, they are indifferent as to the form of payment the GP ultimately receives.[85] Consider an economically comparable arrangement whereby the GP is entitled to a twenty percent commission on fund profits realized by the LPs. Such a commission would be taxable to the GP's individual partners at ordinary rates,[86] and the LPs would be entitled to a deduction for the distribution.[87] However, because the LPs are tax-exempt, they have no need for the deduction.

It is due to the LPs' tax ambivalence that the parties are amenable to distorting the economics of their compensation regime around a tax-efficient model.[88] This leaves the GP free - and incentivized - to formulate the otherwise unnecessary standard private equity fund partnership structure and two and twenty compensation package. This leaves the Treasury on the short end of the stick.[89] Instead of ordinary rate tax revenue on a commission with tax-exempt

[81] I.R.C. § 1(a), (i); *see* Note, *supra* note 56, at 1780 ("The true culprit behind the carried interest problem is the preferential long-term capital gains rate.").
[82] *See, e.g.*, Pieczonka, *supra* note 12, at 530 (commenting on Warren Buffet's effective tax rate of 17.7% on gross income of $46 million, as compared to his secretary's 30% effective tax rate on gross income of $60,000).
[83] Joint Comm. on Taxation, *supra* note 3, at 53-54 (If the GP and the LPs have the same marginal tax rates, then the tax benefit of the GP is offset perfectly by the tax detriment to the LPs).
[84] Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money,"* YALE L. J. 506, 509-10 (1986) (pointing out that the benefit and detriment do not precisely offset one another where the taxpayers are not subject to the same rate of taxation).
[85] Fleischer, *supra* note 2, at 13-14.
[86] I.R.C. § 61(a); I.R.C. § 702(b).
[87] I.R.C. § 162(a)(1) (providing a deduction for services rendered).
[88] Fleischer, *supra* note 2, at 13-14.
[89] *Id*. at 13-14 (commenting that the gap between the economics of carried interests and their tax treatment creates a rational incentive for exploitation); *see also* Joint Comm. on Taxation, *supra* note 3, at 53-54 (noting that, if the GP and the LPs were subject to the same rate of taxation, and if the LPs were able to deduct compensation included in the GP's income, no aggregate tax advantage to the parties taken together would result from electing to use a

LPs absorbing the offsetting deduction, the Government is left with capital gains rate taxes on carried interest appreciation. This is so even though the GP places none of its own capital at risk by accepting a partnership profits interest instead of a right to a commission on fund profits.

C. Illustration

The following illustration depicts the taxation of a private equity fund manager's carried interest income under current law. The example is greatly simplified for the sake of clarity.[90] The same example is used for purposes of comparison in evaluating reform proposals.[91]

The following facts are assumed: 1) Kraken Capital, L.L.C. is a private equity firm with two individual members, Ares and Hades, each holding an equal fifty percent membership interest; 2) Kraken manages only one investment fund, PE Fund, L.P., which has an initial capital investment of $200 million, all of which is contributed by its limited partners; 3) Kraken receives a twenty percent carried interest in PE Fund with no hurdle rate; 4) PE Fund invests the entirety of its initial capital in portfolio companies in year one, and its investments appreciate at a constant rate of fourteen percent per year for six years, at which point PE Fund liquidates all investments, and its gains are distributed to Kraken and the limited partners; 5) A constant discount rate of eight percent is assumed for the purpose of present value calculations.

Figure 2 below provides an illustration of the income and taxation of the individual fund managers under current law.

partnership carried interest instead of an ordinary compensation payment, as any tax benefit shifted to the GP would yield a precisely offsetting tax burden on the LPs).

[90] Several layers of complexity could be woven into the example to more closely resemble a real-world private equity fund scenario, such as the addition of a hurdle rate, variable timing of liquidation of fund assets, accounting for capital investment on the part of the GP, accounting for variable rates of return, considering offsetting capital losses from other sources, considering the GP's contemporaneous management fee and transaction fee income and taxation, etc., all of which would impact the present calculations.

[91] *See infra* Sections III,A,2, III,B,2, and IV,B.

Figure 2[92]

Current law

(values in millions of dollars)

Year	Beginning fund value	Growth for period	Ending fund value	Cumulative fund growth	Total carried interest value	Taxes paid on carried interest income	After Tax return to GP	NPV of payments to GP	NPV of Government receipts
0	$ -	$ -	$ 200.00	$ -	$ -	$ -	$ -	$ -	$ -
1	$ 200.00	$ 28.00	$ 228.00	$ 28.00	$ 5.60	$ -	$ -	$ -	$ -
2	$ 228.00	$ 31.92	$ 259.92	$ 59.92	$ 11.98	$ -	$ -	$ -	$ -
3	$ 259.92	$ 36.39	$ 296.31	$ 96.31	$ 19.26	$ -	$ -	$ -	$ -
4	$ 296.31	$ 41.48	$ 337.79	$ 137.79	$ 27.56	$ -	$ -	$ -	$ -
5	$ 337.79	$ 47.29	$ 385.08	$ 185.08	$ 37.02	$ -	$ -	$ -	$ -
6	$ 385.08	$ 53.91	$ 438.99	$ 238.99	$ 47.80	$ 7.17	$ 40.63	$ 25.60	$ 4.52

Under current law, Kraken's initial receipt of the carried interest is a non-taxable event.[93] Since Kraken realizes no income on its carried interest during the operation of the fund, Ares and Hades will not be taxed as the carried interest appreciates. At the end of year six, when PE Fund liquidates, its total value has grown to $438.99 million. Of the $238.99 million in fund profits, Kraken's carried interest entitles it to $47.80 million, evenly allocable to Ares and Hades, according to their membership interests. This amount will be subject to taxation at the long-term capital gains rate of fifteen percent, yielding a total tax obligation attributable to the carried interest income of $7.17 million in year six. Therefore, Kraken has an after tax return of $40.63 million. The net present value Kraken's after tax return in year six is $25.60 million. As is expected, the fund managers will be subject to an effective tax rate of fifteen percent when Kraken receives the carried interest distribution in year six.

II. THE CAPITAL VS. COMPENSATION DEBATE

Putting aside the superficial inequity of current law, it is important to determine if carried interest income is properly characterized as capital or if it is more appropriately treated as

[92] Figure 2 prepared by the author.
[93] Campbell v. Commissioner, 943 F.2d 815 (8th Cir. 1991); Rev. Proc. 93-27, 1993-2 C.B. 343.

compensation for services.[94] A persuasive demonstration that the carried interest is wholly compensatory in nature would demand application of ordinary income tax rates to the income earned therefrom.[95] Similarly, a convincing illustration of the entirely capital nature of the carried interest would vindicate its treatment under current law.[96]

This section compares the arguments in support of ordinary and capital treatment of the carried interest. Due to the tautological circularity of analyzing the carried interest in a vacuum, comparisons to other forms of economic activity are necessary. It is by way of analogy to comparable transactions that one side of the debate would carry the burden of persuasion. However, this article argues that neither side is capable of claiming total victory. Accordingly, a conciliatory acquiescence to the notion that the carried interest is correctly described as having both capital and compensation components is urged.

A. Argument that Carried Interest Income is Fundamentally Compensation for Services

In advancement of the argument that carried interest income is properly characterized as compensation for services, proponents claim that the carried interest is analogous to a contingent fee for service arrangement. It is argued that, regardless of an investment fund's structure, the GP's contribution to the fund's performance primarily involves "the performance of services by individuals whose professional skill generates capital income for investors in the fund."[97]

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[94] Aviva Aron-Dine, *An Analysis of the "Carried Interest" Controversy*, CTR. ON BUDGET & POLICY PRIORITIES 1-5 (Aug. 1, 2007), available at http://www.cbpp.org/7-31-07tax.pdf (noting that equity, revenue implications, and economic efficiency are the reasons that Congress is concerned with carried interests, but the primary focus of reform should be determining whether the carried interest is more analogous to compensation for services or whether the appropriate comparison is to gain from capital).

[95] *See* Joint Comm. on Taxation, *supra* note 3, at 59 (noting that the benefit of increased accuracy of income measurement promotes the perception of fairness, which is essential in a self-reporting income tax system).

[96] *Id*.

[97] *Id*. at 53 (noting further that fund partnership agreements typically include time and effort clauses requiring the GP - and in some cases specific individual fund managers - to perform services in exchange for the carried interest).

Proponents argue that a private equity fund manager is akin to a hired investment advisor working on a performance-based fee arrangement.[98]

This characterization has obvious facial appeal. After all, simply predicating the measure of a service provider's compensation upon the performance of his service recipient's investments does not negate the reality that the former is, in fact, performing services in exchange for said compensation.[99] The individual fund manager is, therefore, adroitly likened to the hired investment advisor working on a contingent bonus arrangement – a tempting analogy.[100]

Ordinary income advocates also argue that the GP is not entitled to preferential capital gains treatment on its carried interest because the GP is not required to risk its own capital.[101] This argument circles back to the contingent bonus driven investment advisor analogy, wherein the service provider who risks his time and his effort, but not his money, pays taxes at ordinary rates on his contingent compensation.[102]

The analogy is particularly compelling when one considers the solely profit-bearing nature of the carried interest. The absence of risk of investment loss is common to both the hired investment advisor's contingent bonus and the fund manager's carried interest.[103] This similarity gives rise to the principal horizontal equity concern that performance-based compensation, when structured by the fund manager as a carried interest, is taxed at the lower capital gains rate, while the hired investment advisor's contingent bonus is taxed at ordinary rates.[104]

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[98] *Id*. at 52-53.
[99] *Id*. at 53 (stating that the simple alignment of the GP's and the LPs' economic incentives does not change the character of the GP's economic activity).
[100] *See* Note, *supra* note 56, at 1780.
[101] *Id*. at 56 ("The fund manager is risking his time and effort, but not his money.").
[102] *Id*.
[103] Aron-Dine, *supra* note 94, at 6.
[104] *Id*. at 55; *see also* Sneed, *supra* note 1, at 574 (those who are equal in their income should bear equal tax burdens).

Back to Table of Contents

B. Argument that Carried Interest Income is Appropriately Characterized as Capital

Those who argue that carried interest income is correctly taxed as capital gains rely upon a different analogy. For these commentators, the appropriate comparison is to an entrepreneur who invests his time and energy to the growth of his business.[105] If the fund managers were to apply their investment skill in the management of their own venture in the same way they work for the benefit of the private equity fund, any gain on the appreciation of their investments would be properly characterized as capital.[106]

The general tax treatment of "sweat equity," a settled feature of business taxation, pursuant to which taxpayers avoid tax on the labor they provide in support of their own businesses, lends credence to the analogy.[107] A business owner may contribute his labor to the growth of his business, but will avoid taxation on that labor upon its sale, the gain on which will be considered capital.[108] In a sense, the tax treatment of sweat equity can be regarded as a justified advantage to the business owner in exchange for sacrificing front-end compensation as an investment in his enterprise.

Applying the entrepreneur sweat equity analogy to the case of the private equity fund manager, a compelling similarity emerges. The fund managers operate as typical entrepreneurs, availing themselves of third party capital and applying their skill set to grow their business, the private equity fund.[109] As the fund operates, the fund managers work hard, investing their sweat to help the fund grow to its potential. When the time comes for the fund to cease operating, the

[105] *See, e.g.*, Weisbach, *supra* note 36, at 739.
[106] *Id*. at 730.
[107] Joint Comm. on Taxation, *supra*, note 3, at 57.
[108] *Id*. The tax treatment of sweat equity is thought to advantage the business owner, as he is able to intertwine what is realistically income from his labor in the appreciation of his business to an extent that it would be prohibitively onerous to untangle. The capital gain treatment of the ultimate sale is an acknowledgment of this administrative difficulty.
[109] Weisbach, *supra* note 36, at 718.

fund managers liquidate their interest, hopefully at a profit, which will be fed on the fruits of their entrepreneurial labor.

Cast in this light, the private equity fund looks no different than most other debt-financed businesses. It is, after all, not uncommon for business ventures to be highly leveraged, and proponents argue that there is no reason to deny the proprietors of this particular species of enterprise the same capital gain treatment on its appreciation that others receive.[110]

C. Argument that Carried Interest Income Consists of Both Capital and Labor Components

The binary analogical approach to characterizing carried interest income as either capital or ordinary confounds the debate. Since it appears that both analogies are somewhat convincing, certainly there must be some measure of accuracy in each.[111] However, certain deficiencies can be identified in both the performance-based compensation and the sweat equity analogies.[112]

1. Insufficiency of the Performance-Based Compensation Analogy

The nature of the business arrangement between the GP and the private equity fund demonstrates that the individual fund managers are, at least in part, performing services in return for the carried interest.[113] However, acknowledging this fact does not necessarily demand a wholesale endorsement of the performance-based compensation analogy. There are certain

[110] Joint Comm. on Taxation, *supra*, note 3, at 57.
[111] *See* Philip F. Postlewaite, *The Taxation of Compensatory Profits Interests: The Blind Men and the Elephant*, 29 NW. J. INT'L L. & BUS. 763, 763-64 (2009) (comparing the capital vs. compensation debate to the Indian fable in which several blind men touch different parts of an elephant. Each man correctly describes what he is touching. However, without the benefit of the full view, none of them can accurately identify the object as an elephant. Applied to carried interests, Postlewaite contends that the ordinary and capital advocates are stuck in the trees of competing analogies, failing to appreciate the forest - that the carried interest is an aggregation of capital gain and ordinary income components).
[112] Note, *supra* note 56, at 1781 (describing the service and capital analogs as both being only partly correct).
[113] *See* Howard E. Abrams, *Taxation of Carried Interests*, 116 TAX NOTES 183, 187 (2007) (contending that it is obvious that the carried interest income is at least some part compensation); *see also* Joint. Comm. on Taxation, *supra* note 3, at 52 (referencing time and effort clauses commonly found in fund partnership agreements, requiring fund managers to perform specified investment management services as consideration for the carried interest).

distinctions between the analogy and a private equity fund manager's carried interest that should give one pause before reaching this conclusion.[114]

First, the structure of the private equity fund partnership itself does not fit the contracted performance-based fund advisor analogy.[115] The performance-based compensation analogy rests upon the assumption that the GP is nothing more than an investment advisor, hired by the LPs to assist in the selection of their investments. The reality of the carried interest transaction compels the recognition that the GP is better regarded as a co-venturer and part owner of the private equity fund, on par with the LPs.[116]

A contracted investment advisor, working for a commission on the appreciation of his client's investments, does not acquire an ownership interest in his client's investment enterprise.[117] As such, the hired investment advisor is not in possession of a capital asset that is subject to appreciation or depreciation during the term of his service. Moreover, the hired investment advisor does not wield the same degree of managerial authority over his client's investments as the GP enjoys in the context of a private equity fund.[118]

It might be noted that the ultimate amount of remuneration in the performance-based compensation analogy equals that of the private equity carried interest, suggesting that the two cases share an equal amount of financial risk.[119] There may be some merit in this observation,

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[114] *But see* Mark P. Gergen, *Reforming Subchapter K: Compensating Service Partners*, 48 TAX L. REV. 69, 94 (1992) (arguing that the decision not to tax the grant of the partnership profits interest under § 83 at the time of transfer justifies the later characterization of the entire realization of income on the carried interest as ordinary).
[115] Weisbach, *supra* note 36, at 739.
[116] *Id*. (noting that the business realities of the relationship between the GP, the LPs, and the fund itself do not permit the conclusion that the GP is merely an agent of the LPs).
[117] *Id*.
[118] Knoll, *supra* note 10, at 121 (explaining that the GP maintains plenary management authority over the private equity fund's investment portfolio, controlling which positions the fund takes and when they are to be liquidated).
[119] *See* Joint Comm. on Taxation, *supra* note 3, at 56 ("Capital gains rates do not apply to employee compensation that is performance-based."); *but see* Cunningham & Schenk, *supra* note 55, at 343 (observing that the existence of risk is not a dispositive factor in determining whether a particular investment or transaction will be accorded capital gains treatment – "The definition of capital asset is not in any way targeted toward 'risky' investments.").

Back to Table of Contents

but that does not mean that the foregoing distinctions are irrelevant. The GP's equity interest in the fund and managerial authority over the fund's investments indicate that the GP is something more than a hired advisor.[120] As an ownership partner in the private equity fund, which makes investments in portfolio companies, it must be conceded that at least some portion of the GP's carried interest income is attributable to capital appreciation on such investments.[121] Therefore, the extreme position that the entirety of the carried interest income is compensation for services cannot be accepted.

2. Insufficiency of the Sweat Equity Analogy

The sweat equity analogy, though facially appealing, also proves to be inadequate. To begin with, it must be noted that, in the sweat equity analogy itself, it is acknowledged that the business owner is converting some amount of income from his labor into capital gain to be realized upon the sale of his business.[122] The capital gain treatment of the ultimate sale is, therefore, more an affirmation of the administrative difficulty entailed in accurately disaggregating the portion of appreciation attributable to the business owner's labor than a contradiction of the labor component's existence.[123]

Another deficiency of the sweat equity analogy is evident in the fact that, ordinarily, "the operating income of a business is taxed at ordinary rates as it is earned."[124] In the case of the GP's carried interest, operating income is deferred until a sale of a fund portfolio asset occurs, at

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120 Weisbach, *supra* note 36, at 739.
121 *Id*. at 719 (noting that the private equity fund is involved in making investments in portfolio companies, and there is a longstanding central premise of partnership taxation treating the partners as though they engaged in this activity directly); *but see* Darryl K. Jones, *Sophistry, Situational Ethics, and the Taxation of the Carried Interest*, 29 NW. J. INT'L L. & BUS. 675, 683 (2009) ("The value of an equity interest attributable to human capital ought to be taxed at a certain constant rate, whether the human capital is expended by a partner or an employee.").
122 Joint Comm. on Taxation, *supra* note 3, at 57.
123 *See* Weisbach, *supra* note 36, at 756 (arguing that there is no way to draft tax legislation that will accurately identify any potential service portion of the capital appreciation).
124 Joint Comm. on Taxation, *supra* note 3, at 57.

which time the GP's operating income from providing investment advisory services is converted into capital gain.[125]

It is evident then that the proper sweat equity analogy in the private equity context would be to an individual fund manager's sale of his capital interest in the GP, not the GP's ongoing carried interest income.[126] This distinction acknowledges the fact that the GP is a discrete entity, operating outside the fund itself. Accordingly, the individual fund manager's labor is absorbed as sweat equity in the GP and not the fund. A blend of the individual fund manager's labor and capital subsists in the GP, and any sale of his capital interest would be a sale of his portion of the accumulated and previously taxed yields of the GP.[127] Clearly, this would not be the case for the carried interest income.

3. Carried Interest Income as an Aggregate of Capital Gain and Compensation

Based on the foregoing analysis, it is plain to see that neither of the extreme analogies seeking to identify the character of carried interest income as either capital or ordinary is entirely accurate.[128] Still, those seeking to tax the GP's carried interest returns at ordinary rates focus on the service analogy and maintain that the carried interest is fundamentally an item of compensation.[129] Conversely, those advocating maintenance of the status quo center their analyses on the entrepreneur analogy and contend that capital treatment is appropriate due to the

[125] *Id*.
[126] *Id*. at 58.
[127] Jones, *supra* note 121, at 706 (arguing that the sweat equity analogy is more aptly directed at a sale of a GP capital account, not carried interest income earned on a fund portfolio liquidation).
[128] Note, *supra* note 56, at 1781.
[129] *See, e.g.*, Fleischer, *supra* note 2, at 51 (advocating a simplistic baseline whereby the GP's carried interest income would be taxed at ordinary rates in the period of realization); Mark P. Gergen, *A Pragmatic Case for Taxing an Equity Fund Manager's Profit Share as Compensation*, 87 TAXES 139, 139 (Mar. 2009); Jones, *supra* note 121, at 675; Satyanarayana, *supra* note 45, at 1615 (advocating disregard of pass-through treatment when partnership profits interests are used as compensation); Henry Ordower, *Taxing Service Partners to Achieve Horizontal Equity*, 46 TAX LAW. 19, 41 (1992).

administrative impossibility of accurately parsing out the service component of the carried interest.[130]

The obduracy of those on both sides of the capital vs. ordinary debate is not entirely without foundation. A corollary to the acknowledgment that each of the competing analogies is deficient is the consequent admission that both sides are at least partly correct.[131] However, this is not to say that choosing one of the two extremes is the only available option.[132] A superior approach to meaningful tax reform begins with acknowledging that income from carried interests consists of both capital and ordinary components.[133] Acquiescing to this conceptual understanding moots the capital vs. compensation debate. It is only by doing so that one is able to move beyond splitting hairs and proceed to the business of seeking the solomonic sweet spot where this baby might finally be split.

The problem of taxpayers succeeding in blending capital and compensation income in order to achieve capital gains treatment on the aggregate is not unique to carried interests, nor is it a particularly new phenomenon.[134] Difficult as the task may be, the recognition that the GP has

130 *See, e.g.*, Weisbach, *supra* note 36, at 755 (defending the status quo based on the administrative impossibility of separating the service component of carried interest income; noting that "cash flows do not come neatly labeled as capital or labor"); Philip F. Postlewaite, *Fifteen and Thirty-Five – Class Warfare in Subchapter K of the Internal Revenue Code: The Taxation of Human Capital upon the Receipt of a Proprietary Interest in a Business Enterprise*, 28 VA. TAX REV. 817, 881 (2009) (commenting on the administrative burden of overlaying additional complexity on top of an already convoluted Subchapter K and insisting that the status quo appears superior to reforms that would recharacterize carried interest income as ordinary); Adam H. Rosenzweig, *Not all Carried Interests are Created Equal*, 29 NW. J. INT'L L. & BUS. 713, 735 (2009) (endorsing the sweat equity analogy and advocating maintenance of capital treatment of carried interests, but with implementation of a holding period that would treat income from positions transferred earlier as non-preferred short-term capital gains).

131 Note, *supra* note 56, at 1781.

132 *Id.*; *but see* Weisbach, *supra* note 36, at 749 (discussing the necessity of "line drawing" in partnership taxation, pursuant to which a partner in a given transaction must be regarded in one of two possible postures – as a partner or as a service provider).

133 Note, *supra* note 56, at 1781.

134 Stanley Surrey, *Definitional Problems in Capital Gains Taxation*, 69 HARV. L. REV. 985, 985 (1956) (identifying the treatment of capital gains and losses as the subject responsible for the most complexity in the Internal Revenue Code).

engaged in an economic distortion[135] in order to smuggle service compensation into a capital asset compels an attempt to disaggregate the GP's carried interest income into a service component and a capital component.[136]

Disaggregating carried interest income would entail bifurcating the single carried interest income stream into separate modules consisting of labor return and investment return on reinvested compensation income.[137] The labor return would be subject to taxation at ordinary rates, and the remaining portion designated as capital would be taxed at the advantageous capital gains rate.[138] Concededly, there is no reliable way to do this accurately.[139] However, the acknowledgment that both components exist requires an effort to identify the reform alternative that disaggregates the carried interest into its constituent service and capital particulates the best.

III. EVALUATION OF LEGISLATIVE AND ACADEMIC PROPOSALS TO REFORM THE TAXATION OF INCOME FROM CARRIED INTERESTS

Disaggregation of carried interest income represents a pragmatic vehicle for compromise reform, allowing the policy purists on either side of the capital vs. ordinary debate to claim partial victory.[140] A disaggregationist comparison of current carried interest taxation and proposals premised on total ordinary income treatment appositely accounts for the current tax policy stalemate. Current law, out of administrative expedience,[141] effectively rounds down the service component of carried interest income to zero and treats the entire taxable aggregate as

[135] Fleischer, *supra* note 2, at 13-14.
[136] Note, *supra* note 56, at 1781.
[137] Karen C. Burke, *The Sound and Fury of Carried Interest Reform*, 1 COLUM. J. TAX. L. 1, 18 (2010).
[138] *Id*.
[139] *See Id*. at 43 ("Disaggregation may present a fundamentally insoluble problem"); *see also* Weisbach, *supra* note 36, at 755 (noting the impossible task of identifying the service component embedded within the carried interest income stream).
[140] Note, *supra* note 56, at 1782 (commenting that disaggregation facilitates political compromise because it permits the competing policy arguments to coexist, rather than arbitrarily selecting one extreme over the other).
[141] *See* Jones, *supra* note 121, at 684 ("Expediency in tax jurisprudence is not without value, but because it is situational, it cannot replace enduring values in a body of law that is itself ultimately and expression of social values rather than the objective conclusion of economic science.").

capital gain upon realization.[142] Similarly, a regime based on total ordinary income treatment would round down the capital component to zero, completely ignoring the entrepreneurial aspects inherent in the GP's activity.[143]

A long held tenet of tax policy is that horizontal equity ought to be a principal ambition of tax legislation.[144] Little, if any, detailed explanation is necessary to ascertain how a tax regime that completely ignores the service aspect of the GP's carried interest income violates this principle of basic fairness.[145] As compared to other yields attributable to a taxpayer's services, the fund manager escapes with a substantially smaller tax burden. On the other hand, though many will be loath to regard private equity fund managers as victims of horizontal inequity, it could likewise be argued that the same principle would be violated in the instance of total ordinary income treatment.

The difficulty is in identifying the appropriate taxpayer analog for the private equity fund manager.[146] He is unique in a way, although clearly situated somewhere between two competing extremes. Reform proposals should respect this reality and dispense with the dogma of exact comparisons for purposes of horizontal equity analysis.[147] At the outset, however, it is sufficient to note that the extent to which the principle of horizontal equity is offended by total capital treatment of carried interest income compels the conclusion that "the status quo is untenable as a matter of tax policy."[148]

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[142] Fleischer, *supra* note 2, at 41.
[143] *See* Abrams, *supra* note 7, at 219-20 (arguing that any proposed solution to the carried interest problem should respect the policy decision to subsidize "entrepreneurial risk-taking" by means of preferential capital gains taxation).
[144] *See* David Elkins, *Horizontal Equity as a Principle of Tax Theory*, 24 YALE L. & POL'Y REV. 43, 43-44 (2006) (describing horizontal equity as a principle that "demands that similarly situated individuals face similar tax burdens. It is universally accepted as one of the more significant criteria of a 'good tax.'").
[145] Jones, *supra* note 121, at 710-11.
[146] *See* Elkins, *supra* note 144, at 44 ("Horizontal equity is concerned with individuals who are similarly situated").
[147] *Id*. ("Requiring that exact taxpayers be treated exactly alike would gut the ethic of horizontal equity.").
[148] Fleischer, *supra* note 2, at 4.

Reform alternatives are varied in their approaches to solving the carried interest problem.[149] This article presumes that, in the interest of horizontal equity, any carried interest reform should approach the problem in a disaggregationist fashion. Reform proposals that effectively disaggregate the service and capital components of carried interest income typically come in one of three forms.[150]

The first of these subjects a predetermined portion of the amounts realized on the carried interest to tax at ordinary rates[151] This approach represents the only reform proposal to date that has been seriously considered by Congress.[152] The second taxes the appreciation of the GP's capital account annually at ordinary rates, relying on the fund partnership's internal accounting

[149] *See, e.g.*, Gergen, *supra* note 114 (suggesting taxation of all compensatory distributional shares as salary payments, subject to taxation at ordinary rates and burdening the GP with self-employment taxes; Pieczonka, *supra* note 12, at 553-55 (taxing the GP's carried interest income at ordinary rates on the basis of § 1221(a), classifying portfolio investments as the GP's inventory); Jobs Creation and Tax Cuts Act of 2010, S. 3793, 111th Cong., § 402, sec. 710 (subjecting seventy-five percent of the income from a GP's carried interest income attributable to positions held for under five years – fifty percent for positions held for five years or more - to tax at ordinary rates); Brunson, *supra* note 19, at 106-08 (using a "simplified mark-to-market approach" that estimates the GP's service income by reference to the fund's capital accounts and taxes the GP at ordinary rates on an annual basis and deeming the service income to be reinvested, with the ultimate appreciation thereon to be subject to capital gains rate taxation); Fleischer, *supra* note 2, at 52-54 (presenting a "cost-of-capital" approach that would deem a nonrecourse loan to have been granted from the LPs to the GP to purchase a capital interest in the fund, with the forgiven interest thereon taxable to the GP at ordinary rates on an annual basis); Rosenzweig, *supra* note 130, at 746-47 (advocating application of a holding period that would subject a portion of the carried interest income to taxation at the non-preferred short-term capital gains rate, while leaving the remainder subject to the beneficial long-term capital gains rate); Postlewaite, *supra* note 130, at 888-89 (arguing for continued capital gain treatment, but suggesting broader reform through the elimination of § 83(b)).

[150] In addition to the following disaggregative reform proposals, it would be conceivable to perform a retroactive forced valuation of the carried interest to bifurcate taxation into capital and ordinary components. Under such a regime, the benefit of hindsight could be used to provide the appropriate value that should have been taxed as ordinary income as an exchange of property for future services under § 83. For each fund position, the initial value of the portion of the fund manager's carried interest attributable to the fund position could be retroactively determined based on its ultimate value at liquidation. The initial value could be retroactively imputed to the fund manager in the year of grant and taxed as ordinary income under § 83, leaving the growth taxable in the year of liquidation as capital gains. This approach, though intuitively a clean method of disaggregating the carried interest returns, ignores circumstances inherent to the private equity fund investment process. Namely, the carried interest is worth nothing until the fund deploys capital to make investments. Therefore, a retroactive forced valuation would yield the present value of a particular fund investment at the time the investment is made, not the present value of the carried interest at the time the carried interest is granted.

[151] *See, e.g.*, S. 3793, 111th Cong., *supra* note 149, discussed *infra*, Section III, A.

[152] *See* Abrams, *supra* note 7, at 211-12 (detailing the lineage of proposed I.R.C. § 710, first introduced in the House of Representatives by Rep. Charles Rangel in October, 2007 as H.R. 3970 and later as H.R. 3996, and a modified version introduced in the Senate by Sen. Max Baucus in September, 2010 as S. 3793).

to provide an estimate of the appropriate amount of taxable income.[153] This article disregards this second variety of disaggregative reform proposals because of its reliance on annual valuations of illiquid fund portfolio investments[154] and its requirement of a fundamental alteration of the carried interest arrangement in deeming income to be earned annually, as opposed to the time of realization.[155] The last form is known alternatively as the interest charge[156] or cost-of-capital[157] approach, which approximates the service component of carried interest income by means of forgiven interest on a deemed loan from the LPs to the GP to purchase a capital interest in the private equity fund.[158]

This section introduces and analyzes the Congressional proportionate recharacterization approach and the cost-of-capital approach.

A. Proposed Section 710 – Treating a Predetermined Portion of Carried Interest Income as Ordinary at Realization

1. Description

Proposed section 710 represents a crude attempt at disaggregating carried interest income into its constituent capital and labor components. When the GP realizes income on its carried interest, proposed section 710 would recharacterize a predetermined portion of the proceeds as ordinary, without regard to its partnership level character.[159]

If the carried interest income is attributable to a fund position held for less than five years, proposed section 710 treats seventy-five percent of the income as ordinary.[160] In the case

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[153] Brunson, *supra* note 19, at 106-08.
[154] *Id*. at 109
[155] *Id*.; Fleischer, *supra* note 2, at 38-39, n. 159 ("A mark-to-market system could not function because it would assign a value to the fund each year based on current market value and tax any gain or allow a deduction of a loss even though the gain or loss would not have been realized.").
[156] Cunningham & Engler, *supra* note 39, at 126-27.
[157] Fleischer, *supra* note 2, at 52-54.
[158] *Id*.
[159] S. 3793, *supra* note 149 § 710(a)(1)(A).
[160] *Id*. § 710(g)(7)(A).

of positions held for at least five years, proposed section 710 recharacterizes only fifty percent of the carried interest income as ordinary.[161] The remainder of the carried interest income retains its partnership-level character.[162]

2. Illustration

The following illustration describes the taxation of a private equity fund manager's carried interest under proposed section 710. The same simplified example is used.[163] Kraken manages a private equity fund, which has an initial capital investment of $200 million, all contributed by the LPs. Kraken receives a twenty percent carried interest with no hurdle rate. PE Fund invests the entirety of its initial capital in portfolio companies in year 1, and its investments appreciate at a constant rate of fourteen percent per year for six years, at which point PE Fund liquidates. A constant discount rate of eight percent is assumed for the purpose of present value calculations.

Figure 3 below provides an illustration of the income and taxation of the individual fund managers under proposed section 710.

Figure 3[164]

Proposed section 710

(values in millions of dollars)

Year	Beginning fund value	Growth for period	Ending fund value	Cumulative fund growth	Total carried interest value	Taxes paid on carried interest income	After Tax return to GP	NPV of payments to GP	NPV of Government receipts
0	$ -	$ -	$ 200.00	$ -	$ -	$ -	$ -	$ -	$ -
1	$ 200.00	$ 28.00	$ 228.00	$ 28.00	$ 5.60	$ -	$ -	$ -	$ -
2	$ 228.00	$ 31.92	$ 259.92	$ 59.92	$ 11.98	$ -	$ -	$ -	$ -
3	$ 259.92	$ 36.39	$ 296.31	$ 96.31	$ 19.26	$ -	$ -	$ -	$ -
4	$ 296.31	$ 41.48	$ 337.79	$ 137.79	$ 27.56	$ -	$ -	$ -	$ -
5	$ 337.79	$ 47.29	$ 385.08	$ 185.08	$ 37.02	$ -	$ -	$ -	$ -
6	$ 385.08	$ 53.91	$ 438.99	$ 238.99	$ 47.80	$ 11.95	$ 35.85	$ 22.59	$ 7.53

[161] *Id*. § 710(g)(7)(B).
[162] *Id*. § 710(g)(3) (aggregate amount treated as ordinary income to be allocated ratably among the various items comprising the carried interest income).
[163] *See supra*, Section I,C.
[164] Figure 3 prepared by the author.

As with current law, under proposed section 710, Kraken realizes no income on its carried interest during the operation of the fund. At the end of year six, when PE Fund liquidates, its total value has grown to $438.99 million. Of the $238.99 million in fund profits, Kraken's carried interest entitles it to $47.80 million. Because the underlying fund investments were held for over five years, fifty percent of this amount is recharacterized as ordinary and subject to tax at the top marginal ordinary income rate of thirty-five percent.[165] The remaining fifty percent retains its partnership-level capital character and is subject to long-term capital gains tax of fifteen percent.[166] This yields a total tax obligation attributable to the carried interest income of $11.95 million in year six. Therefore, Kraken has an after tax return of $35.85 million. The present value Kraken's after tax return in year six is $22.59 million. Kraken's effective tax rate on the carried interest distribution is twenty-five percent.

By recharacterizing half of the GP's carried interest income, proposed section 710 effectively siphons an additional $4.78 million in tax revenue from the GP, as compared to current law in this example. Note however, if PE Fund were to liquidate immediately prior to the closing of year five,[167] when the carried interest value is $37 million, proposed section 710 would assess a nearly equivalent tax burden of $11.1 million on substantially less income, increasing Kraken's effective tax rate to thirty percent.

3. Analysis

At first blush, proposed section 710 is an improvement over current law in that it recognizes the dyadic nature of carried interest income by disaggregating it into an ordinary and a capital portion. However, an obvious and justifiable criticism available to detractors is that it

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[165] S. 3793, *supra* note 149, sec. 710(a)(1)(A).
[166] *Id*. § 710(g)(3).
[167] *Id*. § 710(g)(7)(B).

achieves disaggregation by means of a crude, fixed-ratio formula.[168] It is difficult to ascertain the justification for the seventy-five percent baseline recharacterization for carried interest income attributable to fund positions held for less than five years. Clearly, the ratio reflects an assumption that the preponderance of carried interest income is compensation for services.[169] However valid such an assumption may be, a crude, one-size-fits-all ratio is a clumsy way to effectuate the position.

Moreover, the capricious fifth year milestone reduction to fifty percent recharacterization could give rise to an indefensible result. Ostensibly, two similarly situated GP's receiving equal returns on a carried interest but liquidating them just days apart would face an effective tax rate disparity of five percent.[170] An arbitrary milestone such as this could unduly influence a GP's decision to hold or liquidate a fund position, rendering the underlying private securities even more illiquid than they already are until the fifth anniversary of the fund's investment.[171] Not to mention, such a regime would undoubtedly tax nearly identical taxpayers with nearly identical income at different rates – a violation of horizontal equity principles within the microcosm of individual private equity fund managers.[172]

Criticisms aside, proposed section 710 addresses the macro horizontal equity concerns that persist under current law. In fact, the provision would tax a fund manager's carried interest neatly between the range of entrepreneurial capital gains and performance-based compensation.

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[168] Note, *supra* note 56, at 1789.
[169] *See* Snyder, *supra* note 44, at 1462 (commenting that advocates of proposed section 710 regard the carried interest arrangement as more akin to performance-based compensation).
[170] S. 3793, *supra* note 149, § 710(g)(7)(A), (B).
[171] In effect, a miniature, temporal lock-in could occur until the ratio adjusts at the end of year five, due to the imminent easing of the GP's tax obligation on the ultimate liquidation of the position, which would be a most troublesome result. *See* Cunningham & Schenk, *supra* note 55, at 344-45 ("The lock-in of accrued gains is said to create inefficiency that impedes the flow of capital to its most productive uses.").
[172] Sneed, *supra* note 1, at 574.

Most importantly, proposed section 710 does so in a relatively tidy fashion, with easily administrable and predictable results.[173]

For those who are persuaded by the unsophisticated,[174] but nonetheless compelling, argument that basic fairness demands the recharacterization of a preponderance of carried interest income, proposed section 710 represents a solid approach to solving the carried interest problem.[175] In contrast, those more partial to the scalpel than the broadsword are reluctant to accept proposed section 710 as a tolerable disaggregative approach to taxing carried interest income.[176]

B. Approximating the Labor Component of Carried Interest Income through a Cost-of-Capital Approach

1. Description

Under a cost-of-capital approach to taxing carried interest income, the LPs are deemed to grant a nonrecourse loan, amounting to the carried interest percentage of contributed capital, which the GP is then deemed to use to purchase a corresponding capital interest in the private equity fund.[177] Proponents of this approach contend that a twenty percent partnership profits interest is economically equivalent to a nonrecourse, zero interest demand loan of twenty percent of the contributed capital when the GP uses it to invest in the private equity fund.[178] This contention is plainly meritorious, given the fact that the parties could precisely replicate the

[173] *See* Cunningham & Engler, *supra* note 39, at 126 (noting that proposed section 710 is very simple to apply).
[174] *See* Jones, *supra* note 121, at 711 ("Though horizontal equity has undeniable intuitive and populist appeal, [opponents] nevertheless reject it because horizontal equity cannot be expressed in the sophisticated terms [opponents] rely upon to obscure the precise inequity they seek to discount. Most axiomatic truisms are incapable of sophistication.").
[175] Cunningham & Engler, *supra* note 39, at 126.
[176] *See, e.g.*, Snyder, *supra* note 44, at 1451 ("[Congress's] broad proposal to recast carried interest from capital gains into ordinary compensation is overly punitive and misguided.").
[177] Fleischer, *supra* note 2, at 39.
[178] *Id*. at 40. Even critics of carried interest reform agree with the suitability of the cost-of-capital analogy. *See, e.g.*, Weisbach, *supra* note 36, at 734 ("The closest analogy to a profits interest is a nonrecourse loan.").

economics of the carried interest transaction if such a loan were physically made.[179] The GP is functionally a capital partner in the fund, but the fund partnership's losses still fall entirely on the LPs because the loan is nonrecourse, so the synthetic transaction achieves the same economic effect as a carried interest.[180]

Under the cost-of-capital approach, the GP recognizes income annually equal to an interest rate, multiplied by its share of fund profits, multiplied by the capital contributed to the fund.[181] The LPs are regarded as charging interest to the GP on the deemed loan.[182] However, because the GP does not in fact pay the interest, the LPs end up with offsetting interest income and expense for interest forgiveness, and the GP ends up with imputed income based on discharge of the interest obligation.[183] The GP's imputed interest forgiveness, therefore, serves as a proxy for the service component of the GP's carried interest income.[184]

Section 7872 principles require that the GP's forgiven interest obligation be taken as ordinary income each year in the amount of the loan, multiplied by the short-term applicable federal rate of interest - currently 0.28 percent.[185] Section 7872 also allows the GP a

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[179] *See* Cunningham & Engler, *supra* note 39, at 126. Congress was mindful of this economic equivalence in crafting proposed section 710. *See* S. 3793, *supra* note 149, § 710(d)(8)(A) (providing that proceeds of partnership loans not treated as qualified capital interest of service providing partners).

[180] Note, *supra* note 56, at 1792; *see also*, Leo L. Schmolka, *Taxing Partnership Interests Exchanged for Services: Let Diamond/Campbell Quietly Die*, 47 TAX L. REV. 287 (1991) (explaining that, even if it is imperative to tax the economic value of a partnership profits interest, it is unnecessary to do so upon receipt, given the proper economic analogy to § 7872, governing compensation-related and other below-market interest rate loans).

[181] Fleischer, *supra* note 2, at 39.

[182] *Id*.

[183] *Id*. at 40; *see also* Halperin, *supra* note 84 (discussing tax treatment of zero interest and below market interest loans).

[184] Fleischer, *supra* note 2, at 40.

[185] I.R.C. § 7872(a) (providing that forgone interest on a below-market demand loan be treated as a transfer from lender to borrower; I.R.C. § 7872(f) (setting interest rate for calculating forgone interest on demand loans as equal to the short-term applicable federal rate); Rev. Rul. 2012-13, table 1 (setting the annual short-term applicable federal rate of interest at 0.28% for the month of May, 2012); There is some debate as to which applicable federal rate should be used. *See* Fleischer, *supra* note 2, at 40, n. 164 (discussing whether the loan from the LPs to the GP is better regarded as a demand loan, treated under § 7872(a) or a below market interest term loan with original issue discount, pursuant to which the GP would recognize imputed income under § 7872(b); *see also* Cunningham & Engler, *supra* note 39, at 135 (making a non-specific reference to government's risk-free rate); Note, *supra* note 56, at 1792 (assuming the long-term applicable federal rate is the appropriate interest rate). The nature of the deemed

Back to Table of Contents

corresponding interest expense in the same amount as the imputed interest income.[186] However, under section 163(d), the investment interest expense can be deducted only against investment income.[187] Thus, within the confines of the carried interest transaction, the imputed service income will offset an equal amount of the investment income attributable to the carried interest, in effect increasing the GP's basis for purposes of capital gains taxation.[188] This leaves the remaining carried interest not previously taxed at ordinary rates subject to tax at capital gains rates.[189]

2. Illustration

The following illustration describes the taxation of a private equity fund manager's carried interest under the cost-of-capital approach using the same example from previous sections.[190] A constant short-term applicable federal rate of 1.00 percent is assumed for purposes of calculating imputed service income attributable to the interest forgiven on the deemed loan.[191]

Figure 4 below provides an illustration of the income and taxation of the individual fund managers under the cost-of-capital approach.

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loan dictates the outcome of this debate. Since the terms of the fund partnership, and indeed the investments made with respect to a given tranche of capital, are open-ended, this article assumes that the deemed loan is better characterized as a demand loan, rather than a term loan. Accordingly, for purposes of illustrations and calculations, this article will assume the short-term applicable federal rate is the appropriate selection. I.R.C. § 7872(f)

[186] I.R.C. § 7872(a)(1)(B). *See* Cunningham & Engler, *supra* note 39, at 130, n. 47 ("The latter interest expense makes economic sense as it explains why the service provider does not in fact end up holding the initial compensation imputation as additional cash in hand.") Allowing the deduction is critical to avoid double taxation of the GP's imputed income, once at ordinary rates, and again at capital gains rates at the time the carried interest income is received. Id. at 129.

[187] I.R.C. § 163(d)(1).

[188] Fleischer, *supra* note 2, at 42.

[189] *Id*.

[190] *See supra*, Sections I,C and III,A,2.

[191] Although the current short-term applicable federal rate of interest for May, 2012 is set at 0.28%, the historical rate is typically higher. An illustration utilizing the current unusually depressed rate would not be illustrative of the cost-of-capital approach's outcome in a more stable economic environment.

Back to Table of Contents

Figure 4[192]

Cost-of-Capital Approach

(values in millions of dollars)

Year	Initial fund value	Growth for period	Ending fund value	Cumulative fund growth	Total carried interest value	Taxes paid on Imputed service income	Effective Basis in carried interest	Taxes paid on carried interest accretion	After Tax return to GP	NPV of payments to/from GP	NPV of Gov't receipts
0	$ -	$ -	$ 200.00	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
1	$200.00	$ 28.00	$ 228.00	$ 28.00	$ 5.60	$ 0.14	$ 0.40	$ -	$ (0.14)	$ (0.13)	$ 0.13
2	$228.00	$ 31.92	$ 259.92	$ 59.92	$ 11.98	$ 0.14	$ 0.80	$ -	$ (0.14)	$ (0.12)	$ 0.12
3	$259.92	$ 36.39	$ 296.31	$ 96.31	$ 19.26	$ 0.14	$ 1.20	$ -	$ (0.14)	$ (0.11)	$ 0.11
4	$296.31	$ 41.48	$ 337.79	$ 137.79	$ 27.56	$ 0.14	$ 1.60	$ -	$ (0.14)	$ (0.10)	$ 0.10
5	$337.79	$ 47.29	$ 385.08	$ 185.08	$ 37.02	$ 0.14	$ 2.00	$ -	$ (0.14)	$ (0.10)	$ 0.10
6	$385.08	$ 53.91	$ 438.99	$ 238.99	$ 47.80	$ 0.14	$ 2.40	$ 6.81	$ 40.85	$ 25.74	$ 4.38
Cum.						$ 0.84		$ 6.81	$ 40.15	$ 25.18	$ 4.94

Unlike current law, under the cost-of-capital approach, Kraken recognizes a portion of its carried interest income as compensation during the operation of the fund. Each year, $400,000 in service income is imputed to Kraken on the basis of interest forgiveness on the deemed loan.[193] This amount is taxed at ordinary rates each year, yielding an annual tax obligation of $140,000. Because Kraken has no investment income during the operation of the fund against which to offset the interest expense attributable to the deemed loan, Kraken enjoys a functional increase in basis equal to the imputed service income annually.[194] By the end of year six, Kraken has accumulated $2.4 million in interest expense that can be used to set off a portion of its investment income attributable to the carried interest.[195]

Of the $238.99 million in fund profits, Kraken's carried interest entitles it to a payment of $47.80 million at the end of year six. However, only $45.40 million will be subject to tax as capital gains, as $2.4 million is set off by investment interest expense carried forward pursuant to the deemed loan. Therefore, Kraken will be assessed capital gains tax in year six in the amount

[192] Figure 4 prepared by the author.
[193] I.R.C. § 7872(a).
[194] I.R.C. § 7872(a)(1)(B).
[195] I.R.C. §163(d).

of $6.81 million. Under the cost-of-capital approach, Kraken's cumulative tax payments with respect to the carried interest total $7.65 million - $840,000 as ordinary in years one through six and $6.81 million as capital gains in year six. Therefore, Kraken has an after tax return of $40.15 million. The net present value Kraken's aggregate payments and receipts is $25.18 million. Kraken's effective net rate of tax on the carried interest distribution is sixteen percent.

The cost-of-capital approach succeeds in taxing a portion - albeit a small portion due to the depressed short-term applicable federal rate - of the GP's revenue as compensation. Moreover, it does so during the life of the fund, eliminating some of the GP's deferral benefit. However, it is not difficult to see how the cost-of-capital approach could also overtax a GP whose carried interest fails to generate any distributable profits. The imputed service income accrues regardless of the fund investments' performance.

3. Analysis

The cost-of-capital approach is a theoretically sound method of disaggregating the compensation and capital components of the GP's carried interest income. Its principal advantage over proposed section 710 is that it achieves disaggregation by means of existing code provisions, therefore intruding less into sensitive Subchapter K machinery.[196] By making use of section 7872, the cost-of-capital approach successfully taxes a portion of the carried interest income as compensation during the life of the fund without subjecting the entire carried interest distribution to capital gains tax at liquidation.[197] The deemed loan analogy permits the operation of existing code, treating the economically equivalent carried interest arrangement with consistency, as compared to actual interest free, nonrecourse loans.[198]

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[196] *See* Paul Carman, *Taxation of Carried Interests*, 912 PLI/Tax 46-1, 46-45 (2010) ("The cost-of-capital approach does have the benefit of being less intrusive into subchapter K than the Levin proposal.").
[197] Cunningham & Engler, *supra* note 39, at 132.
[198] *Id*.

The cost-of-capital approach takes a step in the right direction with regard to assuaging horizontal equity concerns under present law.[199] By exposing a portion of the GP's carried interest income to taxation at ordinary rates, the approach recognizes that the individual fund managers are situated somewhere between the prototypical performance-based investment advisor and entrepreneur.[200] The question of whether it is proper to divorce the GP's compensation income from the private equity fund's performance presents a troubling quandary. However, proponents of the cost-of-capital approach insist that the loan-based imputed service income is clearly a superior measurement of the GP's labor-related compensation than either current law or a wholesale recharacterization of the carried interest income at realization.[201]

Still, the nagging concern presented by the cost-of-capital approach is that a GP could apparently be subject to taxation without any actual income to show for it. Indeed, the GP will be subject to tax on the imputed service income before any carried interest income is certain.[202] The introduction of accrual concepts can lead to imprecise measurement of the compensation component, potentially resulting in over-taxation.[203] Proponents argue that divorcing the service income calculation from the fund's performance is actually a benefit because it leaves the GP's

[199] Fleischer, *supra* note 2, at 42.
[200] Note, *supra* note 56, at 1793; Snyder, *supra* note 44, at 1468 ("Taxing a portion, rather than the entirety, of a GP's carried interest as ordinary income may be a way to recognize the risks and sweat equity taken on by private equity and venture capital partners without distorting the economics of the transaction.").
[201] *See* Fleischer, *supra* note 2, at 42.
[202] *Id*. (noting that the GP will make tax payments on the forgiven interest from the imputed loan currently, before the ultimate amount of carried interest income is certain).
[203] *See* Postlewaite, *supra* note 130, at 873 (commenting that the accrual concepts contemplated under the cost-of-capital approach involve guesswork that unavoidably results in either under-inclusion or over-inclusion of compensation income); *see also* Note, *supra* note 56, at 1796 (arguing that the cost-of-capital approach presents accrual-type complications, adding increased administrability expense); *but see* HENRY C. SIMONS, PERSONAL INCOME TAXATION 83 (1938) (promoting the idea that an ideal tax would not limit taxation solely to realized income, a goal arguably more closely achieved under the cost-of-capital approach than under current law).

investment decisions untainted by tax considerations, thereby alleviating lock-in concerns that would persist under proposed section 710.[204]

A related concern is liquidity.[205] The cost-of-capital approach requires the GP to make tax payments on imputed service income before the GP has any receipts from its carried interest with which to satisfy the burden. Proponents often dismiss the liquidity objection as mere "administrability concerns," not rising to the level of valid conceptual objections.[206] Some argue that the two percent management fee provides more than sufficient income for the GP to pay the tax assessable on the imputed service income under the deemed loan on an annual basis.[207]

This response to the liquidity objection is plainly susceptible to criticism. To begin with, simply pointing out that the GP typically has another large stream of steady income in the management fee does nothing to justify a forced reliance on that separate income stream to satisfy the discrete tax obligation on the imputed service income from the deemed loan. It is also worth pointing out that the management fee is already subject to tax at ordinary rates.[208] Moreover, the management fee income may be divided among several individual fund managers, making each taxpayer's marginal sacrifice of a portion of his after-tax income more acute.[209]

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[204] *See* Cunningham & Schenk, *supra* note 55, at 344 (describing the lock-in effect, pursuant to which a taxpayer is reluctant to realize gains on capital assets due to the imposition of tax, as "the most serious argument in favor of a capital gains preference."); Cunningham & Engler, *supra* note 39, at 137-38 (contending that the cost-of-capital approach does not change the treatment of the carried interest at realization and, therefore, does not result in lock-in concerns). Indeed, the intuitive assumption could be that the cost-of-capital approach would, if anything, motivate the GP to liquidate fund assets earlier than it ordinarily would in order to subject a greater portion of the carried interest income to the capital gains preference.

[205] Cunningham & Schenk, *supra* note 55, at 349 ("Liquidity [is] a stumbling block for any proposal curtailing the realization requirement.").

[206] Fleischer, *supra* note 2, at 36.

[207] *Id*. at 37.

[208] I.R.C. § 61(a)(1).

[209] The populist enticement to dismiss private equity fund managers' liquidity concerns is strong, especially taking into account the potential for millions of dollars in guaranteed income in the form of the management fee. However, it is important to note that the GP has a certain amount of administrative cost to satisfy with this revenue stream. Furthermore, the GP will not be the taxpayer that ultimately absorbs the imputed service income tax burden, as this obligation will flow through to the individual fund managers. What was one million dollars in the aggregate to the GP can be reduced to one hundred thousand dollars of management fee income to the individual fund manager. At

Lastly, and perhaps most importantly, the cost-of-capital approach, in relying on the short-term applicable federal rate, as prescribed by section 7872, will typically fall well short of taxing an appropriate portion of the GP's carried interest income as compensation.[210] The applicable federal rate is a risk free interest rate and is clearly not a suitable measure of the GP's true cost of capital.[211] Private equity fund investments tend to be exceptionally risky, generating potentially tremendous rates of return.[212] Therefore, if a cost-of-capital approach is to be adopted, it ought to utilize an interest rate applicable to the deemed loan that is reflective of the GP's actual market cost of capital. Only then would the synthetic loan transaction accurately be characterized as an economic equivalent to the carried interest, yielding an accurate service income proxy through imputed interest forgiveness.[213]

Although the cost-of-capital approach has the drawback of reliance on a deemed transaction that does not occur in reality,[214] its economic congruence with the actual transaction does something to mollify this concern. Most impressively, the cost-of-capital approach uses the economic analog to expressly disaggregate carried interest income into capital and compensation components using existing code provisions.[215] This achievement makes the cost-of-capital approach the superior framework on which to construct carried interest reform. Only three minor

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the smaller scale, it is plain to see that additional taxation of unrealized income could present a significant enough sacrifice to an individual called upon to satisfy the burden from his previously taxed income as to raise legitimate liquidity concerns.

[210] Cunningham & Engler, *supra* note 39, at 135.

[211] Snyder, *supra* note 44, at 1467-68.

[212] Joint Comm. on Taxation, *supra* note 3, at 62.

[213] *But see* Cunningham & Engler, *supra* note 39, at 135 (arguing that any criticism of the interest rates applicable under § 7872 evidences a more general shortcoming of § 7872 itself, and maintaining that it is important to treat the deemed loan the same as other compensatory loans with below-market interest).

[214] *See* Carman, *supra* note 196, at 46-45 ("Whenever a deemed transaction is created, an administrative policy concern arises because it becomes more difficult for ordinary citizens to comply without engaging competent representation.").

[215] Note, *supra* note 56, at 1793.

improvements are suggested to address the approach's shortcomings with regard to interest rates and timing and extent of the imputed service income tax liability.[216]

IV. SPLITTING THE BABY – PROPOSED AGGREGATE COST-OF-CAPITAL BIFURCATION WITH AUGMENTED INTEREST RATE BASED IMPUTATION OF COMPENSATION

This article endorses the cost-of-capital approach to taxing carried interest income. However, this article proposes three modifications to the approach that better accommodate the economic realities of the carried interest arrangement than the naked deemed loan. The first is designed to address liquidity objections, which this article presumes are more defensible than admitted elsewhere.[217] The second is intended to prevent over-taxation of the GP's carried interest income. The final proposed modification more accurately estimates the service component of carried interest income through a more realistic cost of capital measurement.[218]

A. Proposal

The first modification to the cost-of-capital approach that is proposed is to permit the deferral of tax payments assessable on the forgiven interest on the deemed loan until a carried interest realization event occurs.[219] This modification resolves the liquidity objections to the cost-of-capital approach. Since no tax will be due on the imputed service income attributable to the interest forgiveness on the deemed loan until the GP receives a carried interest distribution, the individual fund managers will not be required to set aside other previously taxed income to

[216] *See infra*, Section IV.
[217] *See, e.g.*, Fleischer, *supra* note 2, at 36-37; Brunson, *supra* note 19, at 111-12 (justifying mark-to-market taxation of carried interests at ordinary income rates on an annual basis; arguing that "by nature of an investment fund manager's compensation, investment fund manager's always have sufficient liquidity to pay taxes on carried interest [because] the management fee alone would provide sufficient cash to the investment fund manager to pay tax at ordinary rates on any allocation of carried interest.").
[218] Snyder, *supra* note 44, at 1467-68 (discussing the insufficiency of the applicable federal rate for purposes of cost of capital estimation).
[219] *See* Note, *supra* note 56 (advocating deferral of "annual interest payments until partnership realization events").

satisfy a tax burden on income they have not yet received – and may never receive - under the carried interest arrangement.

This change is necessary to better reflect the economic reality of the carried interest arrangement. The cost-of-capital approach effectively converts contingent income that may, or may not, be received later into a steady stream of guaranteed income on an annual basis. The primary justification for treating a portion of a private equity fund manager's carried interest as compensation is its similarity to the performance-based compensation of a hired investment advisor.[220] However, the investment advisor working for a contingent fee does not recognize income until his client's investment undergoes a realization event and the amount of his contingent fee is determined.[221] This is the case for the obvious reason that the amount of the investment advisor's ultimate commission could increase or decrease, and it would not be appropriate to tax him on the commission until its amount is certain.

The cost-of-capital approach fails in this regard because it detaches the computation of the GP's service income from the profitability of fund investments. However, this can be corrected by permitting deferral of tax payments on the imputed service income pursuant to interest forgiven on the deemed loan. Permitting deferral realigns the cost-of-capital approach with the reality that the GP does not truly have income until fund investments are liquidated.[222] Furthermore, by deferring the GP's tax obligation, the liquidity objection is mooted. The GP has no tax liability until there is a concomitant carried interest distribution with which to pay for it.

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[220] Joint Comm. on Taxation, *supra* note 3, at 52-53.
[221] 26 C.F.R. § 1.451-1(a). It could be argued that, if deferral of the GP's imputed service compensation, pursuant to the deemed loan, is to be permitted, then it attaching an interest rate to the tax liability thereon would be appropriate. This article posits that, because the GP's service compensation is speculative, under the carried interest arrangement, during the entirety of a given portfolio investment, attaching interest to the imputed service income is not appropriate until such compensation is definite.
[222] *See* Jones, *supra* note 121, at 683 ("This article does not take issue with the fact that a service provider who agrees to postpone his ability to consume has no present tax liability.").

The second proposed modification is the obvious companion of the deferral recommended in the first proposed modification. This article suggests limiting the amount of service income imputation under the deemed loan to the amount of carried interest income actually received.[223] The cost-of-capital approach taxes the GP annually on imputed service income attributable to the interest forgiven on the deemed loan whether the fund investments are profitable or not.[224] Such a regime could assess taxes on the basis of a synthetic transaction where the real-world transaction yields no income. This unacceptable result can be avoided by placing a limit on the imputed service income equal to the carried interest distribution.

The central premise of the cost-of-capital approach is that the forgiven interest on the deemed loan serves as a proxy for the service component of the GP's carried interest income.[225] However, the implementation of the cost-of-capital approach has the potential to yield the absurd result where a component of the GP's carried interest income exceeds the aggregate. Conceivably, where fund investments underperform the imputed service income, the GP could be taxed on an amount of imputed income greater than the amount of its real income. This improper outcome can be avoided by setting the upper boundary of the imputed service income equal to the total carried interest distribution.

The combination of the tax deferral and the ceiling on service income imputation operate in tandem to calibrate the cost-of-capital approach to the economic reality of the carried interest. The carried interest is a species of contingent, deferred compensation with investment characteristics. Any reform aiming to modify its taxation should do so within the confines of the economics of the transaction. This entails assessment of tax at the time income is actually earned and limitation of tax exposure to the amount of income actually earned.

[223] *Id*. (proposing to cap the cost-of-capital charges at the amount of partnership profits allocation).
[224] Cunningham & Engler, *supra* note 39, at 126.
[225] Fleischer, *supra* note 2, at 40.

The implementation of the first two proposals relegates the operation of the cost-of-capital approach's deemed loan to solely the task of estimating of the service component of the GP's carried interest income. The final proposed modification addresses the cost-of-capital approach's deficiency in this regard. As proponents concede, section 7872 fails to provide an interest rate suited to the task of calculating the GP's true cost of capital.[226]

This article proposes to amend section 7872(f)(2) to define a new applicable federal rate for nonrecourse loans.[227] The nonrecourse rate would be subject to publication monthly by revenue ruling under section 1274(d), along with the short-term, mid-term, and long-term applicable federal rates.[228] The Secretary of the Treasury would thus be empowered to set a higher applicable federal rate that would be appropriate for calculating the interest assessable on the deemed loan from the LPs to the GP. The modified section 7872 would operate to impute income to the GP in the amount of interest forgiven, just as in the original cost-of-capital model, but calculated on the basis of a more appropriate rate of interest.

This final modification of the cost-of-capital approach addresses the concern that the Code is not currently equipped to provide the appropriate vehicle for applying a market rate of interest to impute service income to the GP on the basis of a deemed loan. In order for the economic equivalence of the deemed loan and the carried interest arrangement to be accepted, a

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[226] Cunningham & Engler, *supra* note 39, at 135 ("The § 7872 approach seemingly comes up short […] since it uses the government's risk-free rate, and the carried interest loan is risky."); Fleischer, *supra* note 2, at 40, n. 164 (discussing the insufficiency of the rates applicable under § 7872); Snyder, *supra* note 44, at 1467-68.
[227] *See* Cunningham & Engler, *supra* note 39, at 135 (responding to the criticism that § 7872 would underestimate the carried interest's service component by arguing that, "if the interest rate under our approach appears too low for the carry, this evidences a more general shortcoming in the current § 7872 interest rate. The appropriate response, then, would be to increase the § 7872 interest rate, or possibly an increased rate for nonrecourse loans."). Cunningham and Engler do not expressly endorse the addition of a new rate for nonrecourse loans, as this article does. Ostensibly they stop short of this due to the daunting task of initiating the requisite legislative action.
[228] *See* I.R.C. §§ 7872(f)(2), 1274(d).

market rate of interest must be applicable to the deemed loan.[229] This modification is essential to the economic analogy and, therefore, patently necessary.

These three proposed modifications maintain the disaggregative thrust of the cost-of-capital approach, separating the GP's carried interest income into a capital component, subject to taxation at capital gains rates, and a service component, subject to taxation at ordinary income rates. However, the improvements allow a cost-of-capital approach to better accommodate the economic reality of the carried interest by providing a mechanism to impute a more accurate quantity of service income to the GP, and by eliminating the approach's incongruous accrual concept of annual service income taxation and its potential to alternatively over-tax or under-tax the service component of the GP's carried interest income.

B. Illustration

The following illustration describes the taxation of a private equity fund manager's carried interest under the proposed aggregate cost-of-capital bifurcation approach using the previous example.[230] A constant nonrecourse applicable federal rate of 8.00 percent is assumed for purposes of calculating imputed service income attributable to the interest forgiven on the deemed loan.[231]

Figure 5 below provides an illustration of the income and taxation of the individual fund managers under the proposed aggregate cost-of-capital bifurcation approach.

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[229] Fleischer, *supra* note 2, at 39 ("The GP's use of the LPs' capital is like a compensatory loan; but for the services provided by the GP, the LPs would charge a market rate of interest on the loan.").
[230] *See supra*, Sections I,C, III,A,2, and III,B,2.
[231] The rate selection is concededly somewhat arbitrary. As in previous examples, a static rate is assumed for the sake of simplicity. Given the inherent risk of the nonrecourse loan, especially considering its intended use as capital for the fund to invest in speculative private securities, the 8% rate is arguably reasonable in the present economic climate. Under the proposal, the Secretary of the Treasury will be empowered to set the appropriate rate for nonrecourse loans on a monthly basis. As with the other applicable federal rates, the proposed nonrecourse applicable federal rate will be subject to monthly fluctuation.

Back to Table of Contents

Figure 5[232]

Proposed Aggregate Cost-of-Capital Bifurcation Approach

(values in millions of dollars)

Year	Initial fund value	Growth for period	Ending fund value	Cumulative fund growth	Total carried interest value	Taxes paid on Imputed service income	Effective Basis in carried interest	Taxes paid on carried interest accretion	After Tax return to GP	NPV of payments to/from GP	NPV of Gov't receipts
0	$ -	$ -	$ 200.00	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
1	$200.00	$ 28.00	$ 228.00	$ 28.00	$ 5.60	$ -	$ 3.20	$ -	$ -	$ -	$ -
2	$228.00	$ 31.92	$ 259.92	$ 59.92	$ 11.98	$ -	$ 6.40	$ -	$ -	$ -	$ -
3	$259.92	$ 36.39	$ 296.31	$ 96.31	$ 19.26	$ -	$ 9.60	$ -	$ -	$ -	$ -
4	$296.31	$ 41.48	$ 337.79	$ 137.79	$ 27.56	$ -	$ 12.80	$ -	$ -	$ -	$ -
5	$337.79	$ 47.29	$ 385.08	$ 185.08	$ 37.02	$ -	$ 16.00	$ -	$ -	$ -	$ -
6	$385.08	$ 53.91	$ 438.99	$ 238.99	$ 47.80	$ 6.72	$ 19.20	$ 4.29	$ 36.79	$ 23.18	$ 6.94

Applying the estimated 8.00 percent nonrecourse interest rate, $3.2 million in service income is imputed to Kraken annually, on the basis of interest forgiveness on the deemed loan. However, under the proposed aggregate cost-of-capital bifurcation approach, the tax assessable on this income is deferred until PE Fund liquidates at the end of year six. This amount is taxed at the top ordinary rate at the end of year six, yielding a tax obligation attributable to the imputed service income of $6.72 million. Because Kraken has no investment income during the operation of the fund against which to offset the interest expense attributable to the deemed loan, Kraken enjoys an effective increase in its basis in the carried interest equal to the imputed service income annually. By the end of year six, Kraken has accumulated $19.2 million in interest expense that can be used to set off a portion of its investment income attributable to the carried interest.[233]

Of the $238.99 million in fund profits, Kraken's carried interest entitles it to a payment of $47.80 million at the end of year six. However, only $28.60 million will be subject to tax as

[232] Figure 5 prepared by the author.
[233] I.R.C. § 163(d).

capital gains, as $19.2 million is set off by investment interest expense carried forward pursuant to the deemed loan. Therefore, Kraken will be assessed capital gains tax in year six in the amount of $4.29 million. Under the proposed aggregate cost-of-capital bifurcation approach, Kraken's tax due on the carried interest income - all payable in year six - totals $11.01 million: $6.72 million as ordinary and $4.29 million as capital gains. Accordingly, Kraken's after tax return is $36.79 million. The present value of Kraken's after tax income on the carried interest is $23.18 million. Kraken's effective tax rate on the carried interest distribution is slightly over twenty-three percent.

The proposed modifications to the cost-of-capital approach achieve a realistic bifurcation of the GP's carried interest income into reasonably proportioned capital and service components. Notably, contrary to the cost-of-capital approach, the proposed version does not under-tax the service component in this example. Were this a case in which the fund investments underperformed the interest rate on the deemed loan, the proposed version would also not over-tax the GP, while the cost-of-capital approach would assess tax on imputed income in excess of actual income.

CONCLUSION

After six years in the spotlight, private equity fund managers can still count themselves among the unintended beneficiaries of the capital gains preference.[234] Without being required to risk a dollar of their own capital, these individuals can potentially earn millions in income that will be taxed at the charitable rate of fifteen percent. This is so despite the fact that a large portion of their income is attributable the performance of services, which are usually subject to

[234] *See* Thomas J. Brennan and Karl S. Okamoto, *Measuring the Tax Subsidy in Private Equity and Hedge Fund Compensation*, 60 HASTINGS L. J. 27, 58-59 (2008) (concluding that private equity fund managers enjoy tax-related risk/reward propositions that are superior to wage earners, corporate executives, and entrepreneurs, even though all of the foregoing are offered an opportunity to convert their human capital into wealth).

tax at ordinary rates.[235] This result is achieved through the distortive process of structuring performance-based compensation as a carried interest instead of a straightforward commission.[236]

A proper approach to reforming carried interest taxation begins with the acknowledgment that the carried interest is neither entirely capital, nor entirely compensatory in nature.[237] Once one abandons the hopeless prospect of splitting hairs over which of its economic counterparts the carried interest arrangement better resembles, the answer becomes clear. The carried interest is best regarded as an aggregate of capital and compensation components, and it should, therefore, be taxed accordingly. A sound approach to taxing carried interest income aims to disaggregate the capital and compensation portions and tax them each independently.[238]

Congress has tried to address the issue of carried interest taxation.[239] However, its proposed amendment to Subchapter K is at best a crude and potentially heavy-handed attempt at disaggregation. By contrast, the cost-of-capital approach to carried interest taxation presents an elegant and feasible solution to the problem. The approach employs the carried interest's economic analog – a nonrecourse loan coupled with a concomitant capital interest purchase – to tease out a convenient proxy for the service component of the fund manager's carried interest income in the form of imputed income from the forgiveness of interest on the synthetic loan.[240] In doing so, the cost-of-capital approach effectively disaggregates the carried interest income stream into a service component, which can be taxed at ordinary rates, and a capital component, which can be taxed at the preferential capital gains rate.

[235] Abrams, *supra* note 113, at 187.
[236] Aron-Dine, *supra* note 94, at 6.
[237] Note, *supra* note 56, at 1781 (arguing that both all-or-nothing analogies are only partly correct, and there is no reason to choose just one of the two extremes).
[238] Burke, *supra* note 137, at 18.
[239] *See, e.g.*, S. 3793, 111th Cong., *supra* note 149.
[240] Fleischer, *supra* note 2, at 40.

The cost-of-capital approach is a solid foundation for carried interest tax reform. However, because its service income imputation machinery operates independently with respect to the performance of fund investments, it has the potential to both over-tax and under-tax the fund manager. In the case of an underperforming fund, the cost-of-capital approach can subject unearned income to taxation by imputing more service income than the total carried interest earnings. Furthermore, because it taxes the imputed service income annually, contingent carried interest income that is as yet unearned is subject to tax, raising legitimate liquidity concerns. Lastly, because the cost-of-capital approach relies on the diminutive risk-free applicable federal rate of interest for the purposes of deemed loan interest calculation, it has the potential to under-value the fund manager's compensation income.

This article proposes an aggregate cost-of-capital bifurcation approach that adopts the capable framework provided in the cost-of-capital approach and addresses the foregoing limitations. The proposal would permit deferral of tax payments on imputed service income and limit the imputation to the amount of the carried interest distribution. These modifications eliminate the potential for over-taxation and under-taxation inherent in the cost-of-capital approach and assuage the liquidity objections to accrual taxation of a contingent income stream that may never yield proceeds. The proposal also includes a modification of the Internal Revenue Code to empower the Secretary of the Treasury to establish an applicable federal rate of interest for nonrecourse loans. This rate would be higher than the risk-free rate and better suited to the deemed loan required to impute the service income component of a fund manager's carried interest income.

Borrowing from the theoretically sound disaggregative cost-of-capital system, this article proposes an improved approach that better accommodates the economic realities of carried interest compensation. The aggregate cost-of-capital bifurcation approach proposed here presents a pragmatic solution to the carried interest debate. Moreover, if Congress were ever so inclined, this proposal has the makings of a natural political compromise, whereby each side of the aisle could blandish the other gratuitously with its willingness to split the baby.

Back to Table of Contents

Prohibiting the Garden Because You Can't See the Curb – the IRS's Inconsistent Enforcement of the 501(c)(3) Prohibitions

Abstract: *Every election year there is commentary on the 501(c)(3) prohibitions against campaigning and substantial lobbyist activity. The majority of these articles discuss the constitutionality of the prohibitions. This article assumes the legitimacy of the prohibitions but questions the method of enforcement. The IRS's approach to enforcement, especially in the last decade, has demonstrated an alarming lack of consistency. This inconsistent pattern of enforcement has adversely affected the conduct of 501(c)(3) organizations, churches in particular, and diverted resources from the IRS's primary goal: the collection of revenue. This inconsistent pattern of enforcement is not wholly the fault of the IRS but rather a predictable result given the piecemeal nature of the prohibitions' development. This article suggests that if Congress would give added guidance on the purpose and scope of the prohibitions, then the problem of inconsistent enforcement would be abated and both the IRS and the tax-exempt organizations would benefit as a result.*

Back to Table of Contents

Prohibiting the Garden Because You Can't See the Curb

Introduction – History Repeats Itself

In 1975, the United States Conference of Catholic Bishops (USCCB) engaged in a large-scale campaign regarding public awareness and education on abortion and the church's stance on it. In response to the USCCB's campaign, Abortion Rights Mobilization Incorporated (ARM) sued both the USCCB and the IRS seeking to compel the IRS to strip the USCCB and the Catholic Church of its tax-exempt status. Among its complaints, ARM contended that the USCCB had violated the 501(c)(3) prohibitions prohibiting campaign activity.[1] The Catholic Church defended, and won, by arguing that the plaintiffs in these cases lacked standing to sue.[2] The merits of the cases were never reached.

The response of the IRS to the ARM cases is significant because history seems to be repeating itself. In late 2011 and early 2012, the USCCB and the Catholic Church engaged in another public awareness and education campaign regarding abortion. However, the 2012 campaign was triggered by a specific provision in the Patient Protection and Affordable Care Act of 2010.[3] Despite this difference, the 1975 and 2012 campaigns contain striking similarities; indeed some portions are indistinguishable.[4]

This article contends, notwithstanding the IRS's inaction in the ARM cases, recent trends by the IRS in the 2004, 2006, and 2008 elections point to a likelihood that the IRS will respond in some manner to the 2012 campaign by the USCCB—despite the fact that the IRS did not intervene in the very similar 1975 campaign.

The statutory language of the 501(c)(3) prohibition has not changed since 1954 but the IRS's enforcement of the prohibition has shifted dramatically towards stricter enforcement in the past few decades. This new atmosphere towards stricter enforcement suggests that the USCCB's conduct which might have been allowable in 1975 is no longer.

This inconsistency of enforcement is not an anomaly but rather the result of the prohibition's piecemeal history and disjointed purposes. The desultory nature of the prohibition has made the task of finding and enforcing a bright-line rule difficult. This article suggests that the IRS—tasked with keeping the children from playing in the street, yet itself unable to discern the curb—has simply declared the yard off limits.

Finally, this article suggests that it is this inconsistency of enforcement and not necessarily the prohibition that is having a chilling effect on communication by tax-exempt entities, including churches, and additional guidance by Congress would go a long way towards improving the system both for the tax-exempt organizations and the IRS.

Part I of this article looks at the history of the prohibition now codified in section 501(c)(3) and responses by the judiciary at various stages of the statute's history. Part II documents the IRS's enforcement of the prohibition and how that enforcement has changed in recent years. Part III applies the emergent rules of enforcement to the conduct of the USCCB and suggests a likely outcome in the event of a challenge by the IRS.

PART I – Judicial and Legislative History

A. Pre-1934 Amendment

The fundamental principles of modern day enforcement can be seen forming as recently as the 1930 decision of *Slee v. Commissioner of Internal Revenue*.[5] The controversy in *Slee* was regarding contributions made to the American Birth Control League (League) and whether or not they were deductible.[6] The governing statute allowed deductions of gifts made to "any corporation organized and operated exclusively for religious, charitable, scientific, literary or educational purposes, including posts of the American Legion or for the prevention of cruelty to children or animals."[7] The primary activity examined by the court was the League's distribution of leaflets to legislators.[8] These leaflets contained both recommendations for changes in the law and also information supporting such changes.[9]

In his analysis, Judge Learned Hand first stated that the League was organized for a charitable purpose; however, he may have been making the reference in a non-statutory sense because he goes on later to determine whether the League fit within the statutorily charitable category of education.[10] Regardless, Judge Hand noted that the success of a charitable organization might require, in an incidental fashion, advocating a change in the law.[11] Judge Hand described several hypothetical situations in which this might be the case; the defining feature in each example was that the "activities are mediate to the primary purpose, and would not, we should think, unclass the promotors. The [political] agitation is ancillary to the end in chief, which remains the exclusive purpose of the association."[12] Advocacy by itself was not enough to deny the protection of the statute. Thus the question turned to "what purpose was this advocacy advancing?" The League hoped to put itself under the statutorily-protected category of education.[13] Judge Hand rejected this, noting that "education" as a charitable purpose did not extend to cases in which people were merely trying "to secure the more general acceptance of beliefs which they think beneficial to the community at large."[14]

Judge Hand's opinion, despite its eloquence, has been highly criticized in academic circles.[15] There are two primary criticisms: 1) that there is no elaboration on what type of activity constitutes the "political agitation" which Judge Hand says Congress has chosen not to "subvene," and 2) that the opinion cites no congressional language, treasury rulings, or case law.[16] Regarding the latter criticism, while it is true that Judge Hand does not cite to any case law when setting out his "exclusive purpose" test, the lower court opinion which was affirmed by Judge Hand does.[17] The lower court opinion relies on the case of *Herbert E. Fales*.[18] Under the

Fales interpretation, to be considered charitable, the organization had to meet three conditions: "(a) It must be organized and operated for one or more of the specified purposes; (b) it must be organized and operated exclusively for such purposes; and (c) no part of its income must inure to the benefit of private stockholders or individuals."[19] When *Fales* and the two *Slee* opinions are viewed together, Judge Hand's inference of a congressional policy of neutrality becomes clear—as does his development of an "exclusive purpose" analysis.

Between Judge Hand's opinion in 1930 and 1934—when the legislature first made its voice heard—several cases expounded on the reasoning of *Slee*. In *Watson v. C.I.R.*, the issue was whether donations to the Citizens League of Cleveland (CLC) constituted deductible income.[20] The governing statute, though amended from the time of *Slee*, relied on the same "operated exclusively for" reasoning.[21] The goals set out in the CLC's constitution included:

> 1) To promote businesslike, honest and efficient conduct of local government; 2) To investigate the administration of local offices and the operation of local laws; 3) To collect and disseminate information relative to local and state government and the conduct of public officials; 4) To induce citizens to take a more active interest in the affairs of government; and 5) To encourage competent men and women to stand for public office; and to support wholesome leadership in public affairs.[22]

To carry out these goals, the CLC participated in various types of public education activities as well as classifying political candidates and offering suggested legislation to law-making bodies.[23] The court's analysis focused on whether or not the CLC's actions in this respect were exclusively educational under the statute.[24] The court focused on the political considerations inherent in the CLC's philosophy and the fact that the goals of the organization could be summed up in the phrase "bringing about of better local government and the election of better fitted men to office."[25] Thus, it was the partisan and political nature revealed in the goal itself as the strongest argument against being exclusively educative—the shaping of government was the end sought, not simply a by-product of pursuing one of the charitable categories.[26]

The analysis used in *Watson*, like *Slee*, was twofold. First determine the purpose of the organization.[27] Second determine whether or not that purpose, as evidenced by its actions, "exclusively" advanced one of the "charitable" purposes described by the statute: "organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals."[28]

This rule was solidified in *Leubuscher v. Commissioner*.[29] In *Leubuscher*, the issue was whether the Manhattan Single Tax Club (Club) fell exclusively into one of the charitable categories.[30] The purpose of the Club was to "advocate the Henry George doctrine and the promotion of social intercourse 'among single tax people.'"[31] The court found that the Club's inherent advocacy purpose prevented it from falling under the education category of the statute; the advocacy, as in *Watson*, was not merely incidental but was rather the goal itself.[32]

It is important to note that in *Slee*, *Watson*, and *Leubuscher*, none of the organizations in question were, at first glance, able to fit into any of the statutorily defined charitable categories—religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals—rather each organization tried to wedge itself, unsuccessfully, into the educational category so that their advocacy activities might be considered incidental to the chief "exclusive" purpose.[33] Thus under this line of cases, the advocacy itself was not a dispositive disqualifier as to deductible status. But the advocacy must have been incidental to one of the protected charitable categories. Likewise education about a non-protected category—e.g. partisan politics—would not have been dispositively disqualifying, if it were genuinely educational. The problem arises in one of two situations: 1) when there is both advocacy and it is about a non-charitable category—such as partisanship; or 2) when a court finds than an organization simply cannot fit within one of the protected categories—even the broad education category—to begin with.

B. The 1934 Amendment and Its Aftermath

The modern day prohibitions of section 501(c)(3) consist of two halves: 1) the "no substantial part" half and 2) the absolute bar on campaigning. Four years after *Slee*, the legislature made its voice in the matter be heard by implementing the "no substantial part" prohibition. The amendment was offered by Senator Pat Harrison; however the driving impetus and primary spokesperson for the amendment was Senator Aiken Reed.[34]

Historical context and legislative history indicate that Senator Reed's primary target with the amendment was the National Economy League (Economy League).[35] The purposes of the Economy League were described by its chairman as "stand[ing] for the preservation of the essential functions of government, including health, education, justice and the protection of life and property. It is the nonessential and the wasteful that we seek to eliminate in all agencies of government, local, state, and federal."[36] The Economy League was a 200,000 member organization with a presence in twenty-four states.[37] The Economy League publically and privately urged members of Congress and the President to veto or support specific pieces of legislation.[38] The Economy League employed staff solely for the purpose of campaigning against legislation which would increase federal expenditures.[39]

Senator Reed noted that the original intent of the bill as it came out of committee was to prevent the deductibility of contributions if the giver made them out of a selfish motivation—i.e. one made to advance the personal interests of the giver.[40] However, the language of the amendment as offered did much more than this; for an organization to qualify as charitable, "no substantial part" of its activities could involve "participation in partisan politics or in carrying on propaganda, or otherwise attempting to influence legislation."[41] Senator Reed recognized that the amendment as it was offered constituted a nuclear option; the bill would apply not only to blatant lobbyist groups like the Economy League but also organizations that none of the sponsors intended it to affect such as the Society for the Prevention of Cruelty to Children.[42] Despite the final amendment's reach being broader than was originally intended by the drafters they did limit the prohibition to activities of which "no substantial part" constituted influence, in so doing they allowed the IRS great discretion in deciding when to bring a challenge.[43]

Some commentators believe that the 1934 amendment was a codification of the *Slee* decision.[44] This view is bolstered by the fact that courts continued to rely on *Slee* even after the amendment's passage.[45] However, in theory, the field occupied by *Slee* and its progeny were overtaken by the "no substantial part" language of the 1934 amendment.

In the 1938 case of *Old Colony Trust Co. v. Welch*, the D.C. federal district court upheld the tax exempt status of donations to a legislatively active, anti-vivisection society.[46] The court did not cite the "no substantial part" language of the 1934 amendment but rather used the "exclusive" analysis of *Slee* and even cited the statutory text prior to the 1934 amendment.[47] In the first part of the analysis, the court questioned if the organization could fit within one of the protected categories of the old statute.[48] The "charitable" category seemed the most likely candidate and the court noted that "it is quite clear that what is done out of good will and a desire to add to the improvement of the moral, mental, and physical welfare of the public generally comes within this meaning of the word 'charity.'"[49] Thus, in the second part of their analysis the court found that the public anti-vivisection education and sponsoring of anti-vivisection legislation was incidental activity to the organizations main "charitable" goal and did not therefore count against the exclusivity of the organizations charitable purpose.[50]

In the case of *Girard Trust Co. v. C.I.R.*, the Third Circuit upheld the tax exempt status of donations to a legislatively active, religious organization.[51] In *Girard*, the conflict was regarding donations to the Board of Temperance, Prohibition and Public Morals of the Methodist Episcopal Church (Board).[52] The Board fell under the governance of the Methodist Episcopal Church and was tasked with the purpose of:

> Promot[ing] voluntary total abstinence from all intoxicants and narcotics, to promote observance and enforcement of all existing constitutional provisions and statutory enactments that suppress the liquor traffic and the traffic in narcotic drugs, to promote the speedy enactment of such legislation throughout the world, and to defend and maintain established civil and religious liberties.[53]

The complexity of *Girard* arose from the relationship between the Board and its governing body the Methodist Episcopal Church; the court addressed this relationship in three parts. First, the court noted that religion is a way of life as well as a mental outlook upon the nature of the world and that seeking to influence others was inherent in countless religious groups.[54] Second, from that basis, it was a natural step to "secure the sanction of organized society for or against certain outward practices thought to be essential."[55] Finally, the safeguards against undue extension, influence, and abuse lie in 1) groups which hold opposing views, and 2) constitutional protections "to check that which interferes with freedom of religion for any."[56] These three points made, the court once again turned to Judge Hand's reasoning in *Slee*: notwithstanding a charitable organization's activities straying into the legislative sphere, so long as being in that sphere is incidental to the main purpose of the organization it will not be unclassed.[57]

C. The 1954 Amendment and Its Aftermath

The second half of the modern day section 501(c)(3) prohibition is the absolute bar on campaigning. Of the two halves, this provision has proven much more provocative.[58] What makes the enforcement of this prohibition challenging is the lack of legislative history: there were no hearings, testimony, or discussion on the floor, nor was there any committee or treasury proposal made.[59]

Despite this lack of history, many commentators agree that this amendment, offered by Senator Lyndon Baines Johnson, arose because of two tax-exempt organizations—the Committee for Constitutional Government (CCG) and Facts Forum—which were campaigning for his political challenger Dudley Dougherty. [60] Both organizations claimed to be non-partisan and claimed that their goals were primarily educational in nature.[61]

The first organization, Facts Forum, was an anti-communist organization which disseminated its message through radio and television broadcasting, a Facts Forum periodical, and a news column carried in some 1800 newspapers.[62] The second tax-exempt organization, the CCG, published its own periodical, distributed pamphlets, sent out mailers, and was associated with one of the nation's largest newspaper chains.[63] The CCG became involved in several elections besides that of Senator Johnson.[64] Senator Johnson's specific complaints against CCG were two-fold: 1) they were disseminating information critical of him; and 2) they were soliciting tax-exempt donations to do so.[65]

Senator Johnson asked Gerald Siegel, counsel of the Senate Democratic Policy Committee, to analyze this use of tax-exempt donations for political purposes.[66] Siegel concluded that the CCG could simply claim that its political activity did not constitute a substantial portion of its activities in order to avoid losing its federal tax exemption.[67]

Senator Johnson enlisted the help of Representative John W. McCormack who, three days after Siegel's report, sent a letter to the commissioner of the IRS asking his opinion on the matter and included various published pieces of the CCG which were of a partisan nature.[68] The IRS's response to Representative McCormack's inquiry included history of the 1934 amendment, specifically that a prohibition against "participation in partisan politics" was originally proposed in the amendment but stricken.[69] Apparently the IRS at the time considered this bit of legislative history combined with the "no substantial part" test to mean that little could be done against the CCG activity.[70]

Four days after McCormack's inquiry, Senator Johnson proposed his amendment on July 2, 1954; the scene has been described by numerous commentators:

> Mr. JOHNSON of Texas: Mr. President, I have an amendment at the desk, which I should like to have stated.
> The PRESIDING OFFICER: The Secretary will state the amendment.
> The CHIEF CLERK: On page 117 of the House bill, in Section 501(c)(3), it is proposed to strike out "individuals, and" and insert "individual," and strike out "influence legislation," and insert "influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office."
> Mr. JOHNSON of Texas: Mr. President, this amendment seeks to extend the provisions of section 501 of the House bill, denying tax-exempt status to not only those people who influence legislation but also to those who intervene in any political campaign on behalf of any candidate for any public office. I have discussed the matter with the chairman of the committee, the minority ranking member of the committee, and several other members of the committee, and I understand that the amendment is acceptable to them. I hope the chairman will take it into conference, and that it will be included in the final bill which Congress passes.[71]

The fallout of the amendment was substantial for both sides of the political aisle.[72] To assuage his own tax-exempt backers, Johnson enlisted the help of Siegel once more to clarify the nature of this new provision.[73] On July 3rd, the day after the amendment was proposed, Siegel sent a memorandum to Johnson:

> SUBJECT: Amendment to the Tax Bill respecting political activities of tax-exempt organizations.
> The amendment which you offered and which the Senate adopted to extend the limitations on the activities of tax-exempt organizations under section 501 of the bill (formerly section 101(6)) to prevent intervention in behalf of the political candidacy of anyone running for public office, will have no effect upon labor organizations. Unions, or organizations affiliated with unions such as the CIO Political Action Committee, are not tax-exempt organizations under section 501 and will not in any way be affected by the amendment. I noted in the Washington Post this morning that their statement about the amendment was incorrect. They gave the impression that your amendment included a prohibition on activities "influencing legislation." That provision is already in the law and the only addition, of course, made by your amendment would be to deny tax-exempt status to such so-called charitable or educational organizations if they participate or intervene in any political campaign on behalf of any candidate. The amendment will not have any effect on such organizations as Facts Forum either unless they go beyond their present activities and specifically intervene in political campaigns on behalf of public office candidates. So far as I know they have never done this but have confined themselves entirely to discussions of political issues.[74]

The end result was that the interference from CCG and Facts Forum ceased and Senator Johnson proceeded to win his re-election campaign.[75] Senator Johnson's amendment is often cited in cases involving religious organizations; however there is no evidence that he intended or even considered the amendment's impact on religious organizations.[76] Indeed, there is evidence that Senator Johnson sought support from churches during his campaign.[77]

D. The Aftermath of the 1954 Amendment and the Modern Approach to Section 501(c)(3)

A critical test of the new 501(c)(3) prohibition and its method of enforcement came in the case of *Christian Echoes National Ministry v. U.S.*[78] The Christian Echoes Ministry (Ministry) was established in 1951 to "maintain weekly religious, radio and television broadcasts, to establish and maintain a national religious magazine and other religious publications, to establish and maintain religious educational institutions."[79] The Ministry's articles of faith described both religious and faith based goals[80] as well as distinctly political ideological and policy goals.[81] The Ministry president, Dr. Billy James Hargis, described the mission of the Ministry as to fight against Communism, socialism, and political liberalism.[82] The Ministry distributed a wide range of publications urging readers to support or oppose specific polices and pieces of legislation.[83] The Ministry used its broadcasts to attack political candidates and incumbents that it considered to be too liberal.[84]

In 1966, the IRS revoked the Ministry's tax-exempt status for violating 501(c)(3) in three ways: "(1) it was not operated exclusively for charitable, educational or religious purposes; (2) it had engaged in substantial activity aimed at influencing legislation; and (3) it had directly and indirectly intervened in political campaigns on behalf of candidates for public office."[85]

Christian Echoes'*s* is significant in an examination of enforcement methods in four respects. First *Christian Echoes* re-affirmed that the purpose of the 501(c)(3) prohibition was the same purpose as that explained in *Slee*: the United States Treasury should be neutral in political affairs and avoid subsidizing either attempts to influence legislation or campaign activities.[86] Second, *Christian Echoes* adopted language which covered both direct and indirect forms of influence—defining what exactly constituted an attempt to influence legislation: "Contact[ing], or urg[ing] the public to contact, members of a legislative body for the purpose of proposing, supporting, or opposing legislation; or…[a]dvocat[ing] the adoption or rejection of legislation."[87] Third, for the purposes of determining whether a "substantial part" of an organization's activities constituted a prohibited activity, *Christian Echoes* rejected a percentage test; rather, the court noted that the "political activities of an organization must be balanced in the context of the objectives and circumstances of the organization to determine whether a substantial part of its activities was to influence or attempt to influence legislation."[88] By an analysis of the circumstances and facts surrounding the activity of the Ministry, the court found that the hundreds of exhibits published by the Ministry clearly demonstrated an attempt to influence legislation which was "substantial and continuous" and not merely incidental.[89] The fourth, and perhaps most significant, of the *Christian Echoes* holdings was a recognition that "a religious organization that engages in *substantial* activity aimed at influencing legislation is disqualified from tax exemption, *whatever the motivation*."[90] The court went on to say that this disqualification holds true even if the influence was pursuant to a religious motivation.

If there was any hope of the *Slee* "exclusive analysis" surviving up to this point, *Christian Echoes* conclusively repudiated it with this final holding. Under *Slee*, advocacy itself was not a dispositive indicator of a non-charitable purpose so long as the advocacy was incidental to one of the listed charitable purposes.[91] However, *Christian Echoes* seems to say that even if the advocacy was pursuant to a religious purpose—i.e. a statutory charitable category—it is the act which can disqualify depending on whether the act is sufficiently substantial in its scope.[92] Thus while a religious institution may conduct influential activities, if those activities become a substantial portion of the organizations activities then the organization will lose its charitable status—despite the fact that the activities may be wholly motivated by religious purposes.[93] Stated in a hypothetical situation: presumably 100% of a church's tasks would be religiously motivated, however if 20% of its activities consist of giving shelter and food to the poor, 20% of its activities consist of study and sermons, and 60% of its activities consist of lobbying—even if the lobbying is for clearly religious goals such as fighting for the recognition of religious holidays—such an organization would presumably not qualify under 501(c)(3).

Christian Echoes represents the latest and most significant word by the courts on the enforcement of the "no substantial part" prohibition of 501(c)(3). However, two facts prevent *Christian Echoes* from being as useful as it might be in guiding modern enforcement: 1) the conduct in *Christian Echoes* was blatant[94]—thus the "no substantial part" test was easily applied—and 2) the organization at issue was not a church.[95]

Regarding the second 501(c)(3) prohibition on campaign activity, the courts have been able to draw a slightly clearer line. In *Association of the Bar of the City of New York*, the IRS challenged the New York Bar Association's (Association) tax-exempt status after the organization published a voting guide for elective judgeships at the municipal, state, and federal levels.[96] The voting guide described candidates' professional ability, experience, character, temperament, and special qualifications for office; the voting guide proceeded to rate candidates as either "approved," "not approved," or "approved as highly qualified".[97] The voting guide was then distributed to the Association's members and some 120 other subscribers among which were libraries and law schools.[98]

The Association sought to categorize its activities under the "education" category of charitable activities.[99] Thus, it colored its publication as non-partisan analysis made pursuant to the collection and limited dissemination of objective data.[100] The court found that by organizing the candidates into three categories the analysis went beyond mere data collection and reporting; rather, the objectivity was lost when the association interjected personal feeling and the ratings system constituted expressions of professional opinion.[101] The court expressly rejected the Association's argument that the "substantial part" measure used in the prohibition against influence was intended also to describe the measure of prohibited electioneering: "It should be noted that exemption is lost...by participation in *any* political campaign on behalf of *any* candidate for public office. It need not form a *substantial* part of the organization's activities."[102]

The last case to examine is that of *Branch Ministries v. Rossotti*.[103] On October 30, 1992, four days before the presidential election, a church operated by Branch Ministries placed a full-page advertisement in *USA Today* and the *Washington Times*.[104] This advertisement was headlined "Christians Beware" and asserted that Governor, and presidential candidate, Bill Clinton's positions on abortion, homosexuality, and the distribution of condoms to teenagers in schools violated biblical principles.[105] At the bottom of the ad there was a line identifying the church as the originator of the ad and there were instructions on how to donate to the church.[106] The court found that this was a blatant violation of the 501(c)(3) prohibition on campaigning.[107]

Although *Branch Ministries* primarily dealt with several constitutional issues, it also had important ramifications on enforcement of the prohibition. First, the court noted—in an oft cited line—that the revocation of 501(c)(3) status is likely "more symbolic than substantial."[108] As a church, Branch Ministries would in the future be able to hold itself out as charitable organization and receive tax-exempt treatment so long as when it did so it was not also engaged in prohibited activity as during the 1992 elections.[109] Furthermore, the donors would continue to be able to deduct their donations so long as they were able to establish that at the time the donations were made, the church met the requirements of 501(c)(3).[110] Thus the only thing lost in this sense was the prior assurance both of tax-exempt status for the church and tax deductible status for donations.[111]

The second enforcement-significant pronouncement was the suggestion that a church might permissibly and easily engage in campaigning activities—via a 501(c)(4) counterpart created for such a purpose.[112] The language of 501(c)(4) does not include the same prohibitions on campaigning and legislation-influencing activity, though it does include "exclusive" language similar to that of *Slee*.[113] The D.C. Circuit Court was persuaded by the case of *Regan v. Taxation with Representation*, in which the Supreme Court examined the viability of this set up in which a 501(c)(3) organization had a complimentary 501(c)(4) arm which engages in activity which would be prohibited for the 501(c)(3) organization.[114] Though the Supreme Court had examined this tactic in the context of non-religious charitable organizations, the court in *Branch Ministries* seemed to suggest that the tactic was a viable one to provide a suitably "alternate means of political communication" for churches as well.[115]

For the purposes of this article, *Branch Ministries* is important in two ways: 1) because the organization was actually a church, and therefore would fall into the "religious" protected category—whereas in *New York Bar Association* and *Christian Echoes* the organizations were simply claiming to fall into one of the charitable categories—and 2) the *Branch Ministries* case happened the year of a presidential election—a trait shared with the recent pronouncements by the Catholic Church.

Before moving on to the IRS's patterns of enforcement, it is important to note that both the *New York Bar Association* and the *Branch Ministries* cases involved significant and clear violations of the prohibition against campaigning—in one instance by a non-church charity, and in the other by a church organization. This is in contrast to the *Christian Echoes* decision, which involved a violation of the "no substantial part" prohibition by a non-church charitable organization. To the author's knowledge, there has been no clear case involving a church organization being challenged for a violation of the "no substantial part" prohibition and not, at the same time, the campaigning prohibition. This is significant because where the no campaigning prohibition is a clear and absolute prohibition—and therefore easier to apply—the "no significant part" prohibition, in contrast, requires an examination into the circumstances and facts unique to the situation.[116]

Part II – Enforcement by the IRS of the 501(c)(3) Prohibitions

As the 501(c)(3) prohibition has evolved, the IRS has been tasked with developing a plan of enforcement. However, the prohibition has developed in a piecemeal manner, with various parts highly dependent upon the context and circumstances in which each part was offered and developed. Because of this the IRS's methods of enforcement have not always demonstrated consistency.

A. The IRS's Shifting Stance on the Enforcement Issues

As the courts noted in *Association of the Bar* and again in *Branch Ministries*, the campaigning prohibition is absolute. This is also the position adopted by the Treasury in its regulations.[117] However the IRS has, on occasion, seen fit to allow a "de minimis" amount of activities which could be categorized as "campaigning" in nature.[118]

The de minimis issue is just one of several enforcement questions on which the IRS has initially answered one way and then later adopted a contrary or at least seemingly inconsistent stance. One commentator has identified at least three other questions of enforcement on which the IRS has held to one position on enforcement only to abandon it later.[119]

For example, can an organization engage in campaign speech outside the context of a campaign? In 1976, the IRS took the stance that in order for a charitable organization's activity to constitute "intervention" or "participation" in a campaign, the conduct "would reasonably have to be undertaken in relation to an existing campaign."[120] However in 1989, the IRS recommended revocation of charitable status for an organization which encouraged its members to run for political party precinct committee seats.[121] The IRS general counsel, acknowledging that there was no evidence that any member actually ran, stated that this "raises the issue of whether participation in a political campaign on behalf of any candidate for public office requires participation on behalf of a specific, identifiable candidate. It is our view that a specific, identifiable candidate is not required."[122]

Does the effectiveness of the activity bear upon whether or not an activity is prohibited or not?[123] In 1980, the IRS seemed to indicate yes.[124] The organization in question published a monthly newsletter.[125] The newsletter included the organizations views on legislative, judicial, and administrative issues and urged members to contact various governmental officials to express his or her own views.[126] The newsletter also included voting records of all incumbent members of congress on issues important to the organization and expressed the organization's position on those issues.[127] Despite this content, the IRS said that because the newsletter was not widely distributed (it only reached the organization's membership) it would only "result in a very small distribution in any particular state or congressional district. No attempt will be made to target the publication toward particular areas in which elections are occurring nor to time the date of publication to coincide with an election campaign."[128] Because of this limited effect, the IRS recommended that the organization retain its tax-exempt status. However, in 1989, the IRS, citing *Association of the Bar*, said that "the effort, and not the effect, constitute intervention in a political campaign."[129]

Lastly, does the intent of the organization bear on whether an activity is prohibited or not?[130] In a 1972 revenue ruling, the IRS seemed to say yes.[131] The question revolved around whether a university course which required students to participate in a political campaign of their choosing would violate the prohibition.[132] The IRS did not distinguish the ruling from *Christian Echoes*—which held that the motivation for participation in a campaign was irrelevant.[133] Nor did the IRS suggest that because the students were free to choose the campaign, the treasury's goal of neutrality was not offended. The IRS simply stated that the university in offering such a course had not breached the prohibition on campaigning activity.[134] Then in 1989, the IRS changed course and affirmed that it was the action which was prohibited—not the intent or effect.[135]

B. The 2004 Elections

Perhaps at one point in time, the IRS was content to rest on the broad discretion given to it by Congress and act only in clear cases of violation. But in the 2004 elections, the IRS, prompted by increased complaints, stepped up enforcement efforts and began the 2004 Political Activities Compliance Initiative (PACI).[136] The 2004 PACI covered a six month period which included the Presidential election.[137] The PACI received 164 referrals and investigated 110 tax-exempt organizations in the 2004 elections.[138] These investigations were classified into three categories.[139] The first category consisted of cases pre-dating the 2004 election period.[140] The second category of cases, designated "Type A," included non-complex, often single issue cases.[141] The third category of cases, designated "Type B," included more complex, multiple issue cases.[142] The PACI report further divided the cases in terms of "church" and "non-church."[143] Of the 110 investigations, 47 were church cases and 63 were non-church cases.[144] Of the 40 Type A investigations, 29 were church cases and 11 were non-church cases.[145] Of the 34 Type B investigations, 5 were church cases and 29 were non-church cases.[146] The conclusions of the 2004 PACI program were presented in 2006: 82 investigations had been concluded.[147] Of these, the IRS found violations in 59 cases.[148] In 56 of these cases, the IRS issued a written advisory or assessed an excise tax.[149] In only 3 cases, which involved non-church organizations, the IRS proposed revocation.[150]

C. The 2006 Elections

Due to the high level of non-compliance in the 2004 election, the IRS launched the PACI program for the 2006 election cycle as well.[151] The 2006 PACI covered a nine month non-presidential election period.[152] The number and types of complaints selected for examination in 2004 and 2006 were similar.[153] The Type A and B classifications were retained and a Type C classification was added for egregious/repetitive alleged violations.[154] The 2006 PACI received 237 referrals and selected 100 for examination.[155] This selection consisted of 44 church cases and 56 non-church cases.[156]

As of May 2007, 40 cases were closed: there were no revocations made for either church or non-church organizations; neither were there any revocations for either category; there were 26 instances—4 church and 22 non-church—in which political activity was substantiated and a written advisory was issued; and there were 14 instances—10 church and 4 non-church—in which the alleged political activity was not substantiated upon examination.[157]

D. The Aftermath of the 2006 PACI, a Shift to Education in 2008.

By the 2008 presidential election, and the last year of the PACI program, the focus of the IRS seemed to shift. In the 2004 and 2006 PACIs the focus was entirely on enforcement.[158] In contrast, the 2008 PACI focused more on two goals equally: education and compliance.[159]

Information on the compliance side of the 2008 PACI is scarce; a final report on the program was to be prepared by March 31, 2009. [160] However, as of the date of this article it has not been made available to the public.

Regardless, the 2008 PACI program is noteworthy because of its increased emphasis on educative activities as compared to its predecessors. Specifically there seemed to be a much greater focus on educating exempt organizations of ways to avoid possible prohibited activity.[161] The education covered a wide range of tax-exempt entities.[162] However, most of the education efforts presented simply distilled forms of the information found within Revenue Ruling 2007-41 and Treasury Regulation 1.501(c)(3)-1—both sources long-since available to tax-exempt organizations.[163]

Revenue Ruling 2007-41 described the scope of the tax law ban on political campaign activity for section 501(c)(3) organizations by presenting 21 hypothetical situations and how the law applied in each.[164]

Regarding issue advocacy, the ruling noted that 501(c)(3) organizations may take positions on public policy issues, including those which divide candidates in an election for public office, but care must be taken to avoid any issue advocacy which might constitute political campaign intervention.[165] Thus, even if the communication indicates a candidate in an ancillary fashion—via name, photo, political affiliation, or other distinctive feature of the candidate's platform or biography—it might constitute campaign intervention. Some factors which would be considered in an analysis of this type include:

> Whether the statement identifies one or more candidates for a given public office; Whether the statement expresses approval or disapproval for one or more candidates' positions and/or actions; Whether the statement is delivered close in time to the election; Whether the statement makes reference to voting or an election; Whether the issue addressed in the communication has been raised as an issue distinguishing candidates for a given office; Whether the communication is part of an ongoing series of communications by the organization on the same issue that are made independent of the timing of any election; and Whether the timing of the communication and identification of the candidate are related to a non-electoral event such as a scheduled vote on specific legislation by an officeholder who also happens to be a candidate for public office.[166]

The IRS notes that a communication of issue advocacy is "particularly at risk of political campaign intervention when it makes reference to candidates or voting in a specific upcoming election."[167]

Situations 13 [168], 14[169], and 15[170] of the Ruling each present a hypothetical in which a tax-exempt organization flirts with the line of issue advocacy and political campaign intervention. Sadly none of the three hypothetical scenarios involve a church or religious institution—a unique situation because a form of issue advocacy might be said to occur at least once a week in the form of a sermon by a priest, rabbi, or imam.

However, the three examples are still useful in that while they do not address the unique position held by churches they do provide an application of the listed factors to a situation. What's more, this factor analysis paired with the instructions contained in Treasury Regulation 1.501(c)(3)-1 suggest some likely outcomes should the IRS challenge the USCCB's recent comments as a violation of the 501(c)(3) prohibitions.

Part III. Analysis in the Event of a Challenge to the USCCB's Campaign.

The IRS has in their enforcement of the 501(c)(3) prohibition repeatedly said that any examination will be made based on the entirety of the facts involved. Thus the last part of this article compiles the relevant facts and questions which the IRS might consider when examining the USCCB's conduct for a potential violation.

A) The Activity of the USCCB

The first question to be asked is what activities has the USCCB taken in reaction to the so called "abortion mandate."

The USCCB titled its campaign "Conscience Protection" (CP) and created a CP specific section of the USCCB website.[171] This CP website contains news updates and educational materials on the Patient Protection and Affordable Care Act and the controversial mandate contained therein. The website includes links to comments by religious leaders on this mandate,[172] as well as a "Take Action" section which includes a link to inform visitors of

Back to Table of Contents

impending legislation and recent work by the church on policy efforts.[173] Finally both the "Take Action" website and the CP main website urge visitors to write their congressional representatives and provide a link and instructions on how to do so.[174]

Among the published materials, there have been two video messages from the president of the USCCB. The first is the initial response to the "abortion mandate." The USCCB president concluded his address with the following:

> Never before has the federal government forced individuals and organizations to go out into the market place and buy a product that violates their conscience. This shouldn't happen in a land where free exercise of religion ranks first in the Bill of Rights. *How about letting our elected leaders know that we want religious liberty and rights of conscience restored and the administration's mandate rescinded, we can't afford to strike out on this one*.[175]

Between the uploading of the first and second video messages, the USCCB president met with President Obama. The USCCB president expressed optimism after their meeting at a reconciliation. However, on Feburary 10, 2012, Jacob Lew, President Obama's chief of staff indicated that that there would be no change in the mandate.[176] The USCCB issued a written response to Mr. Lew's comments the same day which read in part:

> We just received information about this proposal for the first time this morning; we were not consulted in advance. Some information we have is in writing and some is oral. We will, of course, continue to press for the greatest conscience protection we can secure from the Executive Branch. But stepping away from the particulars, we note that today's proposal continues to involve needless government intrusion in the internal governance of religious institutions, and to threaten government coercion of religious people and groups to violate their most deeply held convictions. In a nation dedicated to religious liberty as its first and founding principle, we should not be limited to negotiating within these parameters. The only complete solution to this religious liberty problem is for HHS to rescind the mandate of these objectionable services.
> We will therefore continue—with no less vigor, no less sense of urgency—our efforts to correct this problem through the other two branches of government. For example, we renew our call on Congress to pass, and the Administration to sign, the Respect for Rights of Conscience Act. And we renew our call to the Catholic faithful, and to all our fellow Americans, to join together in this effort to protect religious liberty and freedom of conscience for all.[177]

On February 13th, the USCCB president released another video response which included in part the following:

> The church is in the business of reconciliation; so it is not that we hold fast and that we are stubborn ideologues no, but we don't see much sign of any compromise on what was issued on Friday. It is rather disappointing. We didn't ask for this fight. We like to get along and we like to cooperate. How sincere it was when the President when he told me 'We want to work together. We've got a year to work out differences that we honestly admit are there and we want you to be part of it, alright?' It doesn't help when his chief of staff said the other day 'it's over, we've made the only compromise we're going to.' That seems to be in opposition to what his boss, the President of the United States, said to me: 'We've got a year, we can work this out.' I hope it is the latter.[178]

B) A "No Substantial Part" Challenge to the USCCB's Activities.

A challenge may be brought under the "no substantial part" prohibition if it can be shown that the tax-exempt organization is not exclusively organized for one of the exempt activities. Treasury Regulation 1.501(c)(3)-1(c)(3) suggests that an organization is not so exclusively organized if it qualifies as a "action organization."[179]

There are two ways than an organization might via lobbying activities be qualified as a non-exempt action organization. The first way is via an "expenditure test" found in Treasury Regulation 1.501(c)(3)-1(c)(3)(ii) which states in substantial part that:

> "An organization will not fail to meet the operational test merely because it advocates, as an insubstantial part of its activities, the adoption or rejection of legislation. An organization for which the expenditure test election of section 501(h) is in effect for a taxable year will not be considered an action organization by reason of this paragraph (c)(3)(ii) for that year if it is not denied exemption from taxation under section 501(a) by reason of section 501(h).[180]

The expenditure test referred to is the lobbying ceiling amount for 501(h) organizations, this amount is 150% of the lobbying nontaxable amount for a taxable year.[181]

The second way which the IRS has said an organization may violate the "no substantial part" prohibition is the test articulated in *Christian Echoes*: "political activities of an organization must be balanced in the context of the objectives and circumstances of the organization to determine whether a substantial part of its activities was to influence or attempt to influence legislation."[182]

Under this test, the *Girard Trust Co.* decision is instructive.[183] The *Girard* decision concluded with the court finding that "[t]he activities of the Board fell within the type which have been regarded as religious by the Methodist Church for a century and a half. A limitation, if any, upon the deduction granted in general terms of bequests to religious bodies is for Congress to make and Congress has since made it in the 1934 statute."[184] It does not take a great leap of the imagination to perceive the USCCB co-opting a very similar stance in regard to abortion issues. Thus even though the USCCB has encouraged members to contact their representatives and engaged in similar outreach efforts to lawmakers, it will likely be able to characterize those efforts as incidental to the primary religious—and therefore "charitable" under the statute—purpose of the USCCB. This activity cannot grow to the extent articulated in *Christian Echoes* but in its current form would not constitute a violation.[185]

C) A Political Campaign Interference Challenge to the USCCB's Activities

Where the "no substantial part" challenge is not absolute on its ban of a certain type of activity, the political campaign interference challenge is. As such this is a much greater threat to the USBBC campaign, for if any part of their message is considered "campaigning" in nature then they have violated the prohibition.

To determine if a prohibition has occurred requires the application of the Rev. Rul. 2007-41 factors to the USCCB's activities. There are several factors which suggest a violation and several which suggest the opposite.

Back to Table of Contents

Some factors which suggest that a violation has not occurred include: 1) the fact that the communications by the USCCB do not mention that President Obama is engaged in an upcoming re-election bid; 2) the fact that the communications do not make reference to voting or an election; 3) the fact that the communication is a part of an ongoing series of communications by the organization on the issue of abortion and that these communications seem to be made independent of the timing of any election.[186]

Some factors which suggest that a violation has occurred include: 1) the fact that President Obama is highly associated with the law which the USCCB's communications are critical of; 2) the fact that the statement expresses disapproval for President Obama's position on this issue; 3) the timing of the event is during a controversial and highly-contested Presidential election year.

The most important factor will likely be that of timing. On the one hand, the comments were made as a reaction to events independent of any election. On the other hand, the comments were made during an election year—and a hotly contested one at that.

So while it is unlikely that the comments as they temporally stand—made in January and February—would trigger a challenge, what if the exact same comments were made in October and November of the election year?[187] That might very well be enough to tip the scales towards a challenge. It is the closeness of the call that is concerning.

Conclusion

The IRS seems to have taken the approach of a mother who, fearful that her child will wonder into the street, simply says "you cannot play outside." In doing so the boy is deprived of the entire yard for his mother's inability to discern the curb.

Back to Table of Contents

But the fault is not to be placed, wholly or even largely, on the IRS, they are only enforcing a prohibition which does not represent a uniform intent or goal but was rather cobbled together piecemeal over an 80 year period—with each piece highly dependent upon its circumstances.

The IRS itself best summed up the unique challenges it faces in its final report on the 2004 PACI:

> - The activities that give rise to questions of political campaign intervention also raise legitimate concerns regarding freedom of speech and religious expression;
> - The Code contains no bright line test for evaluating political intervention; it requires careful balancing of all of the facts and circumstances;
> - The questionable activities are public and occur within the compressed period of time of the election cycle. Keeping in mind that there are over one million 501(c)(3) organizations, media reports on the activities of a small representation of those organizations can, rightly or wrongly, create an impression of widespread noncompliance; and
> - The activities that must be evaluated for potential campaign intervention can be difficult to document, because they often involve events and statements that may not be recorded or otherwise captured.
> - If the IRS determines prohibited political intervention has occurred, it faces additional challenges: the existing sanctions are limited to assessing penalties based on the amount spent on the intervention, which is often de minimis, or revocation, which may not be in the public interest; and the disclosure restrictions of IRC section 6103 limit IRS's ability to discuss its enforcement actions.[188]

The recent trends in enforcement have resulted in two primary concerns: 1) A "chilling effect" on the speech and conduct of churches and legitimate charitable organizations[189]; and 2) The detraction from the IRS's primary goal: the collection of revenue.[190] As one commentator has noted, "The IRS functions best when engaged in its core function—collecting revenue…It has no special expertise in the regulation of elections, and it has neither the staff nor the expertise to engage adequately in this function."[191]

Back to Table of Contents

If the steady growth of the PACI programs were any indication the problems under the current system of enforcement are not going away but only enlarging, and in doing so diverting more resources from the IRS's primary goal of collecting revenue.[192]

The evolving focus of the PACI program is also cause for concern; the focus is now on education and correcting behavior. The goal of the IRS is no longer on discerning whether or not a black and white violation has occurred—and then reflexively withdrawing tax-exempt status for the period of the violation. Rather the IRS is forced to engage in both a line drawing exercise and the categorization and correction of behavior in order to prevent violations.[193] While a line drawing exercise might be necessary for the "no substantial" part prohibition, the prohibition against campaigning is absolute, there should be no need for the IRS to measure the egregiousness of the conduct but rather reflexively react.[194] If this result is undesirable to Congress—as suggested by the IRS that it might be—then Congress should change the law.[195] But as it stands, the IRS is being drawn into a role it is neither equipped to handle nor one that they were ever intended for: the regulation of election year activities.

Congress would have no shortage of suggestions for an alternative to the current system; the field of suggestions by commentators is vast, and despite significant differences, each demonstrates merit over the current system.[196] One thing most commentators, and it seems even the IRS itself, agree on is that Congress must act. Both the tax-exempt organizations and the IRS would benefit from use of the yard if Congress would just say where the curb is.

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[1] *See* In re United States Catholic Conference, 885 F.2d 1020, 1022 (2d Cir. 1989) (quoting from Complaint at P 26).
[2] *Id.*
[3] The offending provision was dubbed "The Contraceptive Mandate." *See* Secretariat of Pro-Life Activities, *Twelve Things Everyone Should Know About the Contraceptive Mandate*, United States Conference of Catholic Bishops, http://www.usccb.org/issues-and-action/religious-liberty/conscience-protection/upload/Twelve-Things-Everyone-Should-Know-About-the-Contraceptive-Mandate.pdf (last visited May 19, 2012).

[4] *Compare Pastoral Plan for Pro-Life Activities*, A Statement Issued by the National Conference of Catholic Bishops, http://www.priestsforlife.org/magisterium/bishops/75-11-20pastoralplanforprolifeactivitiesnccb.htm (last visited May 19, 2012) ("Thus this Pastoral Plan seeks to activate the pastoral resources of the Church in three major efforts: (1) an educational/public information effort to inform, clarify, and deepen understanding of the basic issues; (2) a pastoral effort addressed to the specific needs of women with problems related to pregnancy and to those who have had or have taken part in an abortion; (3) a public policy effort directed toward the legislative, judicial, and administrative areas so as to insure effective legal protection for the right to life.") *and Bishops Renew Call to Legislative Action on Religious Liberty*, A News Release Issued by the National Conference of Catholic Bishops, http://www.usccb.org/news/2012/12-026.cfm (last visited May 19, 2012) ("We will therefore continue—with no less vigor, no less sense of urgency—our efforts to correct this problem through the other two branches of government. For example, we renew our call on Congress to pass, and the Administration to sign, the Respect for Rights of Conscience Act. And we renew our call to the Catholic faithful, and to all our fellow Americans, to join together in this effort to protect religious liberty and freedom of conscience for all.").
[5] Slee v. Comm'r of Internal Revenue, 42 F.2d 184 (2d Cir. 1930).
[6] *Id*.
[7] *Id*.
[8] *Id*. at 185. The court, despite focusing on the distribution of leaflets, noted that the League's activity extended farther: "[The League] was an unincorporated association, but secured incorporation in New York in September, 1922, and its declared objects were as follows: 'To collect, correlate, distribute and disseminate lawful information regarding the political, social and economic facts of uncontrolled procreation. To enlist the support and co-operation of legal advisors, statesmen and legislators in effecting the lawful repeal and amendment of state and federal statutes which deal with the prevention of conception.' To publish a magazine 'in which shall be contained reports and studies of the relationship of controlled and uncontrolled procreation to national and world problems.' In operation it has gone somewhat further than these projects. It maintains a 'research department' in New York in charge of a physician, a medical, and a clinical, director. married women come to the clinic for advice, are examined, and if in the judgment of the physician their health demands but not otherwise, are told how to prevent conception. Unmarried women are not received. The officials keep elaborate records of the work, follow up the cases, and publish the results at large to the medical profession. At times patients are charged for the service, but the work as a whole goes on at a loss and has to be supported by gifts."
[9] *Id.*
[10] *Id.* (If Judge Hand indeed did believe that the organization was charitable in a statutory sense, it would have been unnecessary for him to engage in analysis of whether it was or was not statutorily charitable later in the opinion: "the question before us is whether the statute covers efforts to proselytize in that or other causes. Of the purposes it defines 'educational' comes the closest, and when people organize to secure the more general acceptance of beliefs which they think beneficial to the community at large, it is common enough to say that the public must be 'educated' to their views. In a sense that is indeed true, but it would be a perversion to stretch the meaning of the statute to such cases.").
[11] *Id.*
[12] *Id.* (One could see the USCCB easily utilizing an argument such as this. (e.g. "Ancillary to advancement of the Christian Faith is the belief that all life is sacred and that is why we must campaign against this mandate."). However, Judge Hand tempered this idea of allowable ancillary advocacy by saying that "When people organize to secure the more general acceptance of beliefs which they think beneficial to the community at large, it is common enough to say that the public must be 'educated' to their views. In a sense that is indeed true, but it would be a perversion to stretch the meaning of the statute to such cases.).
[13] *Id.*
[14] *Id.*
[15] *See* Oliver A. Houck, On the Limits of Charity: Lobbying, Litigation, and Electoral Politics by Charitable Organizations under the Internal Revenue Code and Related Laws, 69 Brook. L. Rev. 1, 19 (2003).
[16] *Id.*
[17] *Slee v. C.I.R*., 15 B.T.A. 710 (1929) *aff'd sub nom Slee v. Comm'r of Internal Revenue*, 42 F.2d 184 (2d Cir. 1930).
[18] *Id.* (citing Herbert E. Fales, 9 B.T.A. 828 (1927)).
[19] *See Fales*, 9 B.T.A. at 831; *see also Slee*, 15 B.T.A. at 714 ("The statutory provisions here involved allow deductions for amounts contributed to: (B) any corporation organized and operated exclusively for religious,

charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual.").

[20] Watson v. Commissioner, 27 B.T.A. 463, 466 (1932).

[21] *Id.* ("Section 23 of the Revenue Act of 1928 reads in part as follows: In computing net income there shall be allowed as deductions: (n) Charitable and other contributions.— In the case of an individual, contributions or gifts made within the taxable year to or for the use of: (2) Any corporation or trust, or community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual.").

[22] *Watson*, 27 B.T.A. at 466.

[23] *Id.*

[24] *Id.*

[25] *Id.* at 468.

[26] *Id.* ("In the instant case the members of the League would perhaps paraphrase the purpose of the League as 'the bringing about of better local government and the election of better fitted men to office.' But in the very statement they assume the soundness of their conclusions and the accuracy of their judgment of fitness. Furthermore, they impute that those not in agreement with the League are mistaken in their philosophy and unsound in their judgment. Any organization such as that under consideration is obviously partisan in the broad sense of that term. It has its own concept of what constitutes good government and its own criteria by which to judge candidates for office, and it suggests its conclusions to others. To this extent it is an advocate. And though advocacy may be but a natural expression of sincerity of belief, it also tends to indicate the point at which education ends and, in this case, political activity begins.").

[27] *Compare Slee*, 42 F.2d at 185 *with Watson*, 27 B.T.A. at 468 (The two decisions seem to support the idea that the advocacy by itself is not evil so long as it is connected to one of the protected areas (i.e. advocacy of religion or education). Likewise education about advocacy/politics is not inherently evil. The problem arises when you have both advocacy about a non-protected area i.e. politics/partisanship.).

[28] *Id.*

[29] Leubuscher v. Comm'r of Internal Revenue, 54 F.2d 998 (2d Cir. 1932).

[30] *Id.* at 999-1000.

[31] *Id.* at 1000.

[32] *Id.* at 1000-01.

[33] *See Slee*, 42 F.2d at 185; *Watson*, 27 B.T.A. at 466-67; *Leubuscher*, 54 F.2d at 1000.

[34] For an excellent and detailed review of the context and purpose for Senator Reed's efforts, see Houck, *supra* note 15 at 21.

[35] *Id.* at 16-17.

[36] R.E. Byrd, *Admiral Byrd Explains Objective of National Economy League*, The Washington Post, Mar. 9, 1933, at 6.

[37] *Urges Veto on Bill For Veterans Pay: National Economy League Asks Hoover to Put Supply Measure Up to Roosevelt*, New York Times, Feb. 37, 1933, at 2.

[38] *Id.*

[39] *Economy League Changes Program: Roosevelt's Federal Reforms Lead to Shifting Emphasis to Local Governments*, New York Times, March 30, 1933, at 19.

[40] *See* 78 Cong. Rec. 5861 (1934).

[41] *Id.* (The final version of the bill omitted the phrase "participation in partisan politics," the only explanation offered was that it was a concession given due to the prohibition being too broad. *See* Houck, *supra* note 15, at 22-23.).

[42] *See* Houck, *supra* note 15, at 21 and 23. (quoting Senator Reed: "There is no reason in the world why a contribution made to the National Economy League should be deductible as if it were a charitable contribution if it is a selfish one made to advance the personal interests of the giver of the money. That is what the committee were trying to reach; but we found great difficulty in phrasing the amendment. I do not reproach the draftsmen. I think we gave them an impossible task; but this amendment goes much further than the committee intended to go.") (78 Cong. Rec. 5861 (1934)).

[43] *See* Houck, *supra* note 15, at 23.

[44] *See* Kevin M. Yamamoto, Taxing Income from Mailing List and Affinity Card Arrangements: A Proposal, 38 San Diego L. Rev. 221, 230 n. 40 (2001).
[45] *See* Old Colony Trust Co. v. Welch, 25 F. Supp. 45, 46 (D. Mass. 1938).
[46] *Id.* at 49.
[47] *Id.* at 46. *See* Cochran v. Comm'r of Internal Revenue, 78 F.2d 176, 178 (4th Cir. 1935) (Both of these cases cite to the pre-amendment wording).
[48] *Id.* at 48-49. (The court spends some time on describing this particular exempt category of "charitable.").
[49] *Id.* at 48.
[50] *Id.* at 47.
[51] *See* Girard Trust Co. v. C.I.R., 122 F.2d 108 (3d Cir. 1941).
[52] *Id.* at 108.
[53] *Id.* at 109, n. 2.
[54] *Id.* at 110.
[55] *Id.*
[56] *Id.*
[57] *Id.* (Judge Goodrich after citing *Slee*, offered additional comment on its reasoning: "[T]he promoters of a charity are not unclassed when the charity seeks a special charter or when a society to prevent cruelty to children seeks positive support of law to accomplish its ends or when a university seeks legislation to provide its appropriations. Surely a church would not lose its exemption as a religious institution if, pending a proposal to repeal Sunday observance laws, the congregation held a meeting on church property and authorized a committee to appear before a legislative body to protest against the repeal.").
[58] *See* Deirdre Dessingue, Prohibition in Search of A Rationale: What the Tax Code Prohibits; Why; to What End?, 42 B.C. L. Rev. 903, 904 (2001).
[59] *See* Vaughn E. James, The African-American Church, Political Activity, and Tax Exemption, 37 Seton Hall L. Rev. 371, 381 (2007); Patrick L. O'Daniel, More Honored in the Breach: A Historical Perspective of The Permeable IRS Prohibition on Campaigning by Churches, 42 B.C. L. Rev. 733, 740-41 (2001); Dessingue, *supra* note 58, at 905.
[60] *See* O'Daniel, *supra* note 59, at 742-43.
[61] *Id.* at 753 and 757.
[62] *Id.* at 753-54, n. 85-87 (Facts Forum described itself as being non-partisan and not participating in any electioning, however there is evidence of promoting a message which was, if not in support of then certainly, parallel to that of McCarthyism.).
[63] *Id.* at 757-58.
[64] *Id.*
[65] *Id.* at 759-60.
[66] *Id.* at 761.
[67] *Id.* at 762.
[68] *Id.* at 763-64.
[69] *Id.* at 764-65; *see* 78 Cong. Rec. 5861 (1934).
[70] *Id.*
[71] 100 Cong. Rec. 8557, 9604 (1954).
[72] *See* O'Daniel, *supra* note 59, at 765.
[73] *Id.*
[74] *Id.* at 765-66 (quoting Memorandum from G.W. Siegel to Lyndon Johnson, July 3, 1954, LBJ Library Pre-Presidential Memo File, Memos to LBJ from Staff 1954.).
[75] *Id.* at 766.
[76] *See* Dessingue, *supra* note 58, at 917 n. 51; James, *supra* note 59, at 384-85.
[77] *See* O'Daniel, *supra* note 59, at 769.
[78] *See* Christian Echoes Nat. Ministry, Inc. v. U.S., 470 F.2d 849 (10th Cir. 1972) (*Christian Echoes* is often cited for its significant first amendment, free exercise, and establishment ramifications involved in the 501(c)(3) prohibition which are beyond the scope of this article. This article assumes the legitimacy of the prohibition and relies on *Christian Echoes* because it was one of the most significant enforcement actions brought by the I.R.S. in the aftermath of the 1954 amendment.).
[79] *Id.* at 851.

[80] *Id.* at 851-52 ("We believe in God, Supreme and Eternal, and in Jesus Christ as His Son, perfect Deity, and in the Holy Comforter and Challenger of this age, The Holy Ghost, and in the Bible as the inspired Word of God…We believe in the fundamentals of New Testament Christianity, and we propose to promulgate the eternal truths thereof at all costs.").

[81] *Id.* ("We believe that the solution of the World's problems, economic, political and spiritual, is found by the application of Christian Teachings in the lives of men and nations rather than in political ideologies of any kind…We believe in constitutional government, whereby religious as well as other freedoms of mankind are preserved and protected.").

[82] *Id.*

[83] *Id.* at 855 (These policies were not necessarily tied—closely or loosely—to any religious purpose: "The court detailed several such efforts: Christian Echoes appealed to its readers to: (1) write their Congressmen in order to influence the political decisions in Washington; (2) work in politics at the precinct level; (3) support the Becker Amendment by writing their Congressmen; (4) maintain the McCarran-Walter Immigration law; (5) contact their Congressmen in opposition to the increasing interference with freedom of speech in the United States; (6) purge the American press of its responsibility for grossly misleading its readers on vital issues; (7) inform their Congressmen that the House Committee on Un-American Activities must be retained; (8) oppose an Air Force Contract to disarm the United States; (9) dispel the mutual mistrust between North and South America; (10) demand a congressional investigation of the biased reporting of major television networks; (11) support the Dirksen Amendment; (12) demand that Congress limit foreign aid spending; (13) discourage support for the World Court; (14) support the Connally Reservation; (15) cut off diplomatic relations with communist countries; (16) reduce the federal payroll by discharging needless jobholders, stop waste of public funds and balance the budget; (17) stop federal aid to education, socialized medicine and public housing; (18) abolish the federal income tax; (19) end American diplomatic recognition of Russia; (20) withdraw from the United Nations; (21) outlaw the Communist Party in the United States; and (22) to restore our immigration laws.).

[84] *Id.*

[85] *Id.* at 852.

[86] *Id.* at 854.

[87] *Id.*

[88] *Id.* at 855.

[89] *Id.*

[90] *Id.* at 854 (emphasis added).

[91] *See Slee*, 42 F.2d at 185.

[92] *See Christian Echoes,* 470 F.2d at 854.

[93] *Id.*

[94] *Compare id. with* See *Project 302 Political Activities Compliance Initiative* (Feb. 24, 2006), http://www.irs.gov/pub/irs-tege/final_paci_report.pdf; *and 2006 Political Activities Compliance Initiative* (May 30, 2007), http://www.irs.gov/pub/irs-tege/2006paci_report_5-30-07.pdf (Where *Christian Echoes* was a blatant violation, many of the IRS's investigations involve borderline cases of de minimis conduct.).

[95] *See 2006 Political Activities Compliance Initiative* (May 30, 2007), http://www.irs.gov/pub/irs-tege/2006paci_report_5-30-07.pdf (Approximately 44-47% of the cases investigated in the 2004 and 2006 elections were involving churches.).

[96] *See* Ass'n of Bar of City of New York v. C.I.R., 858 F.2d 876, 877 (2d Cir. 1988).

[97] *Id.*

[98] *Id.*

[99] *Id.* at 877 (Specifically it incorporated for the purposes of: "cultivating the science of jurisprudence, promoting reforms in the law, facilitating the administration of justice, elevating the standard of integrity, honor and courtesy in the legal profession and cherishing the spirit of brotherhood among the members thereof.").

[100] *Id.* at 880.

[101] *Id.* (The court offered examples to demonstrate the distinction: "A representation that a candidate is a lawyer or a judge is a readily provable statement of objective fact. A representation that a candidate is able and has proper character and temperament is simply a subjective expression of opinion.").

[102] *Id.* at 881 (emphasis added) (In so doing, the court correctly differentiated the electioneering prohibition, which is absolute, from the lobbying prohibition, which is one of degree.).

[103] *See* Branch Ministeries v. Rossotti, 211 F.3d 137 (D.C. Cir. 2000).

[104] *Id.* at 140.
[105] *Id.*
[106] *Id.*
[107] *See id.* at 144-45 (In regard to a selection prosecution complaint, the court noted the uniqueness of the church's actions: "the Church has failed to establish selective prosecution because it has failed to demonstrate that it was similarly situated to any of those other churches. None of the reported activities involved the placement of advertisements in newspapers with nationwide circulations opposing a candidate and soliciting tax deductible contributions to defray their cost.).
[108] *Id.* at 142.
[109] *Id.*
[110] *Id.* at 143 (The court cited 26 U.S.C. § 508(c)(1)(A) which states that generally organizations which seek 501(c)(3) status are presumed at the outset to be private organizations, however an exception to this rule is churchs.)
[111] *Id.* (The court noted, as represented by the IRS, the revocation of the exemption does not "convert bona fide donations into income taxable to the Church. Furthermore we know of no authority, and counsel provided none, to prevent the Church from reapplying for a prospective determination of its tax-exempt status and regaining the advance assurance of deductibility-provided, of course, that it renounces future involvement in political campaigns.") (internal quotes and citations omitted).
[112] This is a topic that has been discussed thoroughly by other commentators. *See* Douglas H. Cook, The Politically Active Church, 35 Loy. U. Chi. L.J. 457, 463 (2004).
[113] *See* IRC § 501(c)(4).
[114] *See* Regan v. Taxation With Representation of Washington, 461 U.S. 540, 543-44 (1983).
[115] *See Branch Ministries*, 211 F.3d at 143
[116] *See* Alexander v. Americans United Inc., 416 U.S. 752, 774-75 (1974) (Blackmun, J., dissenting) (Justice Blackmun in his dissent notes the uncertainty inherent in enforcing the "no substantial part" prohibition.).
[117] *See* 26 CFR § 1.501(c)(3)-1
[118] *See* General Counsel Memorandum 34071 (March 11, 1969) (During the 1960 presidential campaign, a religious organization published materials attacking John F. Kennedy because of his Catholicism. The IRS argued against revocation noting that: "although the regulations are seemingly absolute in their prohibition on political activity, from an administrative standpoint the Service would be justified in telerating [sic] a de minimis amount of political activity…It may well be that political intervention inspired by deeply-held religious convictions furnishes a prime example of a situation calling for application of the de minimis rule.").
[119] *See* Anne Berrill Carroll, Religion, Politics, and the IRS: Defining the Limits of Tax Law Controls on Political Expression by Churches, 76 Marq. L. Rev. 217 (1992) (1) Can an organization engage in campaign speech outside the context of a campaign?; 2) Does the effectiveness of the activity bear upon whether or not an activity is prohibited or not?; 3) Does the intent of the organization bear on whether an activity is prohibited or not?).
[120] *Id.* at 242 (citing GCM 36557 (Jun. 11, 1976)).
[121] *Id.* at 242 (citing GCM 39811 (Jun. 30, 1989)).
[122] *See* GCM 39811 (June 30, 1989).
[123] *See* Carroll, *supra* note 119, at 242.
[124] *Id.* (citing Rev. Rul. 80-282).
[125] Rev. Rul. 80-282
[126] *Id.*
[127] *Id.*
[128] *Id.*
[129] *See* GCM 39881 (June 30, 1989) (citing *Ass'n of Bar of City of New York*, 858 F.2d at 879).
[130] *See* Carroll, *supra* note 119, at 242.
[131] *Id.* (citing Rev. Rul. 72-512).
[132] *See* Rev. Rul. 72-512.
[133] *Id.*
[134] *Id.*
[135] *See* Carroll, *supra* note 119, at 243 (citing GCM 39881 (June 30, 1989)).
[136] *See* Siri Mielke Buller, Lobbying and Political Restrictions on § 501(c)(3) Organizations: A Guide for Compliance in the Wake of Increased IRS Examination, 52 S.D. L. Rev. 136, 154 (2007); *see also* 2006 Political Activities Compliance Initiative (May 30, 2007), http://www.irs.gov/pub/irs-tege/2006paci_report_5-30-07.pdf.

[137] *See 2006 Political Activities Compliance Initiative* (May 30, 2007), http://www.irs.gov/pub/irs-tege/2006paci_report_5-30-07.pdf, pg. 1 n. 1.
[138] *Id.* at 3.
[139] See *Project 302 Political Activities Compliance Initiative* (Feb. 24, 2006), http://www.irs.gov/pub/irs-tege/final_paci_report.pdf.
[140] *Id.*
[141] *Id.*
[142] *Id.*
[143] *Id.*
[144] *See 2006 Political Activities Compliance Initiative* (May 30, 2007), http://www.irs.gov/pub/irs-tege/2006paci_report_5-30-07.pdf, pg. 3.
[145] See *Project 302 Political Activities Compliance Initiative* (Feb. 24, 2006), http://www.irs.gov/pub/irs-tege/final_paci_report.pdf.
[146] *Id.*
[147] *See 2004 Political Activities Compliance Initiative* (Feb. 16, 2004), http://www.irs.gov/pub/irs-tege/one_page_statistics.pdf.
[148] *Id.*
[149] *Id.*
[150] *Id.*
[151] See *2006 Political Activities Compliance Initiative* (May 30, 2007), http://www.irs.gov/pub/irs-tege/2006paci_report_5-30-07.pdf. pg. 1.
[152] *Id.* at 1, n.1.
[153] *Id.* at 3-4.
[154] *Id.* at 2.
[155] *Id.* at 3.
[156] *Id.* at 1 & 3.
[157] *Id.* at 5.
[158] *See 2006 Political Activities Compliance Initiative* (May 30, 2007), http://www.irs.gov/pub/irs-tege/2006paci_report_5-30-07.pdf (The 2006 PACI did have an education component, but it consisted of a single publication—Revenue Ruling 2007-41—whereas in the 2008 PACI education comprised almost one half of all efforts).
[159] *See* Letter from Lois G. Lerner, Director, Exempt Organizations to Marsha Ramirez, Director, Examinations (Apr. 17, 2008), available at http://www.irs.gov/pub/irs-tege/2008_paci_program_letter.pdf.
[160] *See id.*; *see also Final Annual Report Work Plan, Exempt Organizations Division* (November 25, 2008), http://www.irs.gov/pub/irs-tege/finalannualrptworkplan11_25_08.pdf.
[161] *See* Letter from Lois G. Lerner, Director, Exempt Organizations to Marsha Ramirez, Director, Examinations (Apr. 17, 2008), available at http://www.irs.gov/pub/irs-tege/2008_paci_program_letter.pdf.
[162] *See Published Guidance on Political Campaign Activity of 501(c)(3) Organizations*, http://www.irs.gov/charities/charitable/article/0,,id=179773,00.html; *see also Rules for Exempt Organizations During an Election Year*, http://www.irs.gov/pub/irs-tege/election_year_phone_forum_slides.pdf. (last visited May 28, 2012).
[163] *Id.*
[164] Rev. Rul. 2007-41 (Revenue Ruling 2007-41 was preceded by FS 2006-17. The 21 factual situations are the same between the two; however, the IRS describes the instruction language in the FS as plain language and the language in the Revenue Ruling as precedential.).
[165] *Id.*
[166] *Id.*
[167] *Id.*
[168] *Id.* ("*Situation 14.* University *O*, a section 501(c)(3) organization, prepares and finances a full page newspaper advertisement that is published in several large circulation newspapers in State *V* shortly before an election in which Senator *C* is a candidate for nomination in a party primary. Senator *C* represents State *V* in the United States Senate. The advertisement states that S. 24, a pending bill in the United States Senate, would provide additional opportunities for State *V* residents to attend college, but Senator *C* has opposed similar measures in the past. The advertisement ends with the statement "Call or write Senator *C* to tell him to vote for S. 24." Educational issues

have not been raised as an issue distinguishing Senator *C* from any opponent. S. 24 is scheduled for a vote in the United States Senate before the election, soon after the date that the advertisement is published in the newspapers. Even though the advertisement appears shortly before the election and identifies Senator *C*'s position on the issue as contrary to *O*'s position, University *O* has not violated the political campaign intervention prohibition because *the advertisement does not mention the election or the candidacy of Senator C, education issues have not been raised as distinguishing Senator C from any opponent, and the timing of the advertisement and the identification of Senator C are directly related to the specifically identified legislation University O is supporting and appears immediately before the United States Senate is scheduled to vote on that particular legislation*. The candidate identified, Senator *C*, is an officeholder who is in a position to vote on the legislation.") (emphasis added).

[169] *Id.* ("*Situation 15.* Organization *R*, a section 501(c)(3) organization that educates the public about the need for improved public education, prepares and finances a radio advertisement urging an increase in state funding for public education in State *X*, which requires a legislative appropriation. Governor *E* is the governor of State *X.* The radio advertisement is first broadcast on several radio stations in State *X* beginning shortly before an election in which Governor *E* is a candidate for re-election. The advertisement is not part of an ongoing series of substantially similar advocacy communications by Organization *R* on the same issue. The advertisement cites numerous statistics indicating that public education in State *X* is underfunded. While the advertisement does not say anything about Governor *E*'s position on funding for public education, it ends with "Tell Governor *E* what you think about our under-funded schools." In public appearances and campaign literature, Governor *E*'s opponent has made funding of public education an issue in the campaign by focusing on Governor *E*' s veto of an income tax increase the previous year to increase funding of public education. At the time the advertisement is broadcast, no legislative vote or other major legislative activity is scheduled in the State *X* legislature on state funding of public education. Organization *R* has violated the political campaign prohibition *because the advertisement identifies Governor E, appears shortly before an election in which Governor E is a candidate*, is not part of an ongoing series of substantially similar advocacy communications by Organization *R* on the same issue, *is not timed to coincide with a non election event such as a legislative vote or other major legislative action on that issue, and takes a position on an issue that the opponent has used to distinguish himself from Governor E.*") (emphasis added).

[170] *Id.* ("*Situation 16.* Candidate *A* and Candidate *B* are candidates for the state senate in District *W* of State *X.* The issue of State *X* funding for a new mass transit project in District *W* is a prominent issue in the campaign. Both candidates have spoken out on the issue. Candidate *A* supports funding the new mass transit project. Candidate *B* opposes the project and supports State *X* funding for highway improvements instead. *P* is the executive director of *C*, a section 501(c)(3) organization that promotes community development in District *W. At C' s annual fundraising dinner in District W, which takes place in the month before the election in State X, P gives a lengthy speech about community development issues including the transportation issues. P does not mention the name of any candidate or any political party. However, at the conclusion of the speech, P makes the following statement, "For those of you who care about quality of life in District W and the growing traffic congestion, there is a very important choice coming up next month*. We need new mass transit. More highway funding will not make a difference. You have the power to relieve the congestion and improve your quality of life in District *W.* Use that power when you go to the polls and cast your vote in the election for your state senator." *C* has violated the political campaign intervention as a result of *P*'s remarks at *C*'s official function shortly before the election, in which *P* referred to the upcoming election after stating a position on an issue that is a prominent issue in a campaign that distinguishes the candidates.") (emphasis added).

[171] *Conscience Protection*, United States Conference of Catholic Bishops, http://www.usccb.org/issues-and-action/religious-liberty/conscience-protection/ (last visited May 27, 2012).

[172] *Catholic Organizations Respond to HHS "Preventative Services" Mandate*, United States Conference of Catholic Bishops, http://www.usccb.org/issues-and-action/religious-liberty/conscience-protection/upload/Full_List_Webpage_CURRENT.pdf (last visited May 27, 2012) (400 Catholic Leaders signed a letter calling on Congress, the Administration, and the American people to reform the law.).

[173] *Take Action Now*, United States Conference of Catholic Bishops, http://www.usccb.org/issues-and-action/take-action-now/ (last visited May 27, 2012).

[174] *See id*; *Conscience Protection*, United States Conference of Catholic Bishops, http://www.usccb.org/issues-and-action/religious-liberty/conscience-protection/ (last visited May 27, 2012).

[175] *USCCB President Sharply Criticizes HHS Mandate*, United States Conference of Catholic Bishops, http://www.usccb.org/media/video/?bcpid=911432717001&bckey=AQ~~,AAAAdgye3dk~,p0Zv3iru3vKntdSZldOI6IpJ_Ro3rVN6&bclid=987951266001&bctid=1404872889001 (emphasis added) (last visited May 27, 2012).

[176] *See White House Misrepresents Its Own Contraceptive Mandate*, United States Conference of Catholic Bishops, http://www.usccb.org/issues-and-action/religious-liberty/conscience-protection/upload/Response-to-WH-Blog-on-HHS-Mandate.pdf (last visited May 27, 2012).
[177] *Bishops Renew Call to Legislative Action on Religious Liberty*, United States Conference of Catholic Bishops, (February 10, 2012), http://www.usccb.org/news/2012/12-026.cfm.
[178] *Feb. 13: USCCB President responds to the Administration*, United States Conference of Catholic Bishops, http://www.usccb.org/media/video/?bcpid=911432717001&bckey=AQ~~,AAAAdgye3dk~,p0Zv3iru3vKntdSZldOI6IpJ_Ro3rVN6&bclid=987951266001&bctid=1464205617001 (last visited May 27, 2012).
[179] 26 C.F.R. § 1.501(c)(3)–1
[180] *Id.*
[181] IRC 501(h)(2)(B)
[182] *See Christian Echoes*, 470 F.2d at 855.
[183] Both the conduct of the USCCB and the conduct in *Girard* were factually similar: both were campaigns by churches regarding highly publicized social policies. *See Girard*, 122 F.2d 109, n.2.
[184] *See Girard*, 122 F.2d at 110 (The court seemed to apply *Slee* to the newly amended language and retain the idea that even though a charitable organization's activities might put it in a legislative sphere, does not inherently unclass it so long as being in that sphere is incidental to the main purpose which falls in one of the charitable categories.).
[185] *See Christian Echoes*, 479 F.2d at 854.
[186] Besides the factors of Rev. Rul. 2007-4, there are two additional considerations which suggest no violation has occurred: 1) The comments by the USCCB represent views inherently grounded in the religious orthodoxy of the church and have been proclaimed invariably since the issue entered the public's awareness, see Girard, 122 F.2d at 110; 2) The comments were directed towards the executive branch, a non-legislative governing body, this tends to suggest that the comments might be viewed in the non-prohibited class of "general advocacy." *See Rules for Exempt Organizations During an Election Year*, http://www.irs.gov/pub/irs-tege/election_year_phone_forum_slides.pdf (last visited May 28, 2012).
[187] Consider the ad from *Branch Ministries* was published days before voting for the presidential election. *See Branch Ministries*, 211 F.3d at 140.
[188] *See Project 302 Political Activities Compliance Initiative* (Feb. 24, 2006), http://www.irs.gov/pub/irs-tege/final_paci_report.pdf.
[189] *See* Keith S. Blair, Praying for a Tax Break: Churches, Political Speech, and the Loss of Section 501(c)(3) Tax Exempt Status, 86 Denv. U. L. Rev. 405, 431 (2009); Stephanie A. Bruch, Politicking from the Pulpit: An analysis of the IRS's Current Section 501(c)(3) Enforcement Efforts and How It Is Costing America, 53 St. Louis U. L.J. 1253, 1277 (2009); James, *supra* note 59, at 402-03.
[190] *See* Donald B. Tobin, Political Campaigning by Churches and Charities: Hazardous for 501(c)(3)s, Dangerous for Democracy, 95 Geo. L.J. 1313, 1361 (2007).
[191] *Id.* at 1318.
[192] *See* Michael Hatfield, Ignore the Rumors-Campaigning from the Pulpit Is Okay: Thinking Past the Symbolism of Section 501(c)(3), 20 Notre Dame J.L. Ethics & Pub. Pol'y 125, 136 (2006); Tobin, *supra* note 190, at 1361; *see also* 2006 Political Activities Compliance Initiative (May 30, 2007), http://www.irs.gov/pub/irs-tege/2006paci_report_5-30-07.pdf, pg. 7 (Note the minimal amount recovered in connection to improper campaign contributions given by charitable organizations.); Letter from Lois G. Lerner, Director, Exempt Organizations to Marsha Ramirez, Director, Examinations (Apr. 17, 2008), available at http://www.irs.gov/pub/irs-tege/2008_paci_program_letter.pdf (Note the greater emphasis on education rather then enforcement.)
[193] *See* Rev. Rul. 2007-41
[194] *See* Vaughn E. James, Reaping Where They Have Not Sowed: Have American Churches Failed to Satisfy the Requirements for the Religious Tax exemption?, 43 Cath. Law. 29, 78-79 (2004) (Professor James describes the merits of stricter enforcement by the IRS and action by Congress which would provide a brighter line for both the IRS and churches to abide by.).
[195] *See Project 302 Political Activities Compliance Initiative* (Feb. 24, 2006), http://www.irs.gov/pub/irs-tege/final_paci_report.pdf ("the existing sanctions are limited to assessing penalties based on the amount spend on the intervention, which is often de minimis, or revocation, which may not be in the public interest…").
[196] *See id.*; Hatfield, *supra* note 192, at 172-73 (Describing the merits of a taxable church system); Tobin, *supra* note 190, at 1361-62 (Describing a hybrid system in which an independent commission would be tasked with the investigative process, thus unburdening the IRS from the role.); Dessingue, *supra* note 58, at 928 (Suggesting that

Back to Table of Contents

Congress narrow the campaigning prohibition to explicit endorsements or other forms of unambiguous support, thus getting rid of the problems of inconsistency and avoiding the burdens placed on the IRS by attempting to discern where the line is.); Douglas, *supra* note 112, at 473-74 (Suggesting the promotion of churches utilizing 501(c)(4) status.); Bruch, *supra* note 189, at 1286 (Suggesting that both the tax-exempt organizations and the IRS would benefit with the doing-away of the prohibition in its current form.).

Back to Table of Contents

Repealing Oil and Gas Tax Subsidies: A Taxation Anomaly and Alternative Energy Barrier

Table of Contents

I.	Introduction	2
II.	Historical and Current Policies Behind the Oil and Gas Tax Subsidies	4
III.	Oil and Gas Tax Subsidies	7
	A. Percentage Depletion	7
	B. Intangible Drilling Costs	9
	C. Domestic Manufacturing Activity	10
	D. Geological and Geophysical Expenses	11
	E. Passive Loss Exception for Working Interests	13
	F. Deductions for Tertiary Injections	13
	G. LIFO Inventory Accounting	14
	H. Credit for Enhanced Oil Recovery Costs	15
	I. Credit for Enhanced Oil Recovery Costs	15
	J. Marginal Well Tax Credit	16
IV.	General Economic and Environment Considerations in Repealing Subsidies	16
V.	The Repeal of Specific Subsidies	24
	A. Percentage Depletion	24
	B. Intangible Drilling Costs	27
	C. Domestic Manufacturing Activity	28
	D. Geological and Geophysical Expenses	30
	E. Passive Loss Exception for Working Interests	35
	F. Deductions for Tertiary Injections	36
	G. LIFO Inventory Accounting	37
	H. Credit for Enhanced Oil Recovery Costs	38
	I. Credit for Enhanced Oil Recovery Cost and Marginal Well Tax Credit	39
VI.	Conclusion	39

I. INTRODUCTION

Tax deductions and subsidies are a way for the government to encourage greater risk-taking behavior by sharing in the risk of loss with taxpayers.[1] In other words, a tax subsidy is "a specific tax provision that is deliberately inconsistent with an identifiable general rule of the present tax law . . . and that collects less revenue than does the general rule."[2] Subsidies such as these are also called "tax expenditures," defined as losses in revenue from federal income that the government could be receiving.[3] According to calculations by the Joint Committee on Taxation, tax expenditures increased from $36.6 billion in 1967[4] to $1 trillion in 2007[5]. More specifically, the U.S. has foregone $32.3 billion in revenue between 2007 and 2011 due to favorable oil and gas tax deductions.[6] And, without intervention, oil and gas industries will continue to benefit up to $40 billion from tax breaks in the next decade.[7]

During the first three months of 2011, Exxon earned approximately $10 billion, a 69 percent increase in earnings.[8] Society should juxtapose those earnings against a federal government that is heavily in deficit and continues to cut spending.[9] One cannot help but wonder

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[1] Michael Livingston, *Risky Business: Economics, Culture and the Taxation of High-Risk Activities*, 48 TAX L. REV. 163, 168 (1993).
[2] JOINT COMM. ON TAXATION, 110TH CONG., A RECONSIDERATION ON TAX EXPENDITURE ANALYSIS 9 (2008).
[3] *Id.*; MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION PRINCIPLES AND POLICIES 43 (6th ed. 2009).
[4] CONG. BUDGET. OFFICE, TAX EXPENDITURES: BUDGET CONTROL OPTIONS AND FIVE-YEAR BUDGET PROJECTIONS FOR FISCAL YEARS 1983-1987 12 tbl. 3 (1982), *available at* http://ww.cbo.gov/doc.cfm?index=5940&type=1.
[5] Roberta Mann, *Back to the Future: Recommendations and Predictions for Greener Tax Policy*, 88 OR. L. REV. 355, 400–01 (2009).
[6] *Id*. at 403.
[7] Jim Zarroll, *As Gas Prices Rise, Oil Company Tax Breaks Debated*, NPR (Apr. 28, 2011, 6:50PM), http://wap.npr.org/news/Business/135804737?singlePage=true.
[8] *Id*.
[9] *Id*.

if oil and gas companies are paying their fair share of taxes.[10] Especially in this economic atmosphere, the purpose behind financially benefiting certain industries through tax breaks should be compelling.[11]

This Comment discusses which oil and gas tax subsidies should be repealed and why.[12] The Comment concludes that all but one oil and gas tax subsidy should be repealed because the subsidies encourage inefficient spending and investment.[13] In addition, the Comment argues that subsidies no longer support their original purposes, as the global market will continue to support demand for oil and gas even after the repeal.[14] And lastly, subsidies disrupt the alternative energy agenda by skewing investment further in favor of oil and gas.[15] Geological and geophysical deductions, however, should not be repealed.[16] This Comment will even support a more beneficial deduction, instead of an amortized schedule, because advances in research will counter the disadvantages of repealing other subsidies.[17]

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[10] *Id.*
[11] *See id.* (Republican House Speaker John Boehner . . . in his interview with ABC. "We're in a time when the federal government is short on revenues," he said. "We need to control spending, but we need to have revenues to keep the government going. And [oil companies] ought to be paying their fair share.")
[12] *See infra* Parts III–V.
[13] *See infra* Parts IV.A-I, IV.D (arguing that all oil and gas subsidies should be repealed except for deductions for geological and geophysical research).
[14] *See infra* Parts IV.A-I, IV.D (arguing that all oil and gas subsidies should be repealed except for deductions for geological and geophysical research).
[15] *See infra* Parts IV.A-I, IV.D (arguing that all oil and gas subsidies should be repealed except for deductions for geological and geophysical research).
[16] *See infra* Part IV.D (arguing that geological and geophysical deductions should not be repealed because their success will alleviate the negative consequences of tax repeal, by continuing to increase supply and lower costs).
[17] *See infra* Part IV.D (arguing that geological and geophysical deductions should not be repealed because their success will alleviate the negative consequences of tax repeal, by continuing to increase supply and lower costs).

Back to Table of Contents

These solutions can serve to meet the agenda of all parties – creating a more fair and efficient tax system.[18] In concurrence, oil and gas industries are granted a concession that provides an incentive to continue developing innovative and efficient energy solutions.[19] The information and arguments presented can also be applied in consideration of repealing similar tax subsidies for other resources such as timber[20] and minerals.[21]

II. HISTORICAL AND CURRENT POLICIES BEHIND THE OIL AND GAS TAX SUBSIDIES

In the 1970s, oil and gas companies were subsidized for two primary reasons: the first was independence from foreign oil, a value formed during the country's difficulty in coping with the Arab Oil Embargo of 1973,[22] and the second was to support a "fledgling industry" during times of unstable prices.[23] While the oil and gas industry has been subject to many ups and

[18] *See supra* Part III (arguing that one of the reasons for repealing most of the oil and gas subsidies is to create a "fairer" tax system).
[19] *See supra* Part IV.D (arguing that encouraging geological and geophysical research allows oil and gas companies to find other methods to increase supply and lower cost).
[20] *See* John A. Bodgdanski, *Reflections of the Environmental Impacts of Federal Tax Subsidies for Oil, Gas and Timber Production*, 15 LEWIS & CLARK L. REV. 323, 328-37 (2011) (discussing similarities and arguments for the repeal of timber and oil and gas subsidies).
[21] *See generally* Jay Starkman, *The Debate Over Oil and Mineral Taxes*, 125 TAX NOTES 185, 189 (2011) ("[S]imilar treatment in varying percentages was afforded to the owners of iron, coal, sulfur, and metal mines.").
[22] *Domestic Oil & Gas – Tax Proposals to Increase Production: Hearing on S. 971 Before the Subcomm. On Taxation of the Senate Comm. on Finance*, 103d Cong. 172 (1994) (statement by Friends of the Earth), 94-95(((is this the correct formatting?))); *see also What Will the New Millennium Bring? :: Hearing on Energy Security Before the Subcomm. On Energy and Power*, Oct 2, 1998, *available in* 1998 WL 18089263, at *1 (statement of Jay Hakes, Administrator, Energy Info. Admin., Dep't of Energy) ("The importance of energy to the Nation, the importance of gas and oil in the energy mix, the development of cutting edge technology, and the creation of high-skill high-value jobs, makes the gas and oil industry very important to our country").
[23] Mona Hymel, *The United States' Experience with Energy Based Tax Incentives: The Evidence Supporting Tax Incentives for Renewable Energy*, 38 LOY. U. CHI. L.J. 43, 47–48 (2006).

Back to Table of Contents

downs, especially during times of war, those financial deviations were ephemeral.[24] Since the 1990s, the purpose for oil and gas subsidies has been refined to these three reasons: (1) to encourage oil and gas production and exploration in its beginning phase; (2) to compensate for the value differentiation between the private and public sector; and (3) to reduce financial risks and hazards related to oil and gas production.[25] This Comment discusses whether current oil and gas tax subsidies fulfill these purposes.[26]

In America, oil and gas exploration, production, and consumption is a large part of the economy.[27] The United States comprises only 4.5 percent of the world's population, yet it consumes over one quarter of the world's oil and gas.[28] Therefore, sixty percent of the country's oil and gas is imported to meet those needs.[29] Additionally, the oil and gas industry employs over nine million Americans.[30] Even so, the industry continues to grow as the world demand for oil

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[24] Carrie Cecil, *Budget Battles: Would the Obama Administration's Proposal To Eliminate Oil and Gas Tax Subsidies Injure the Industry?*, 8 PITT. TAX REV. 209, 213 (2011).
[25] Hymel, *supra* note 25, at 47.
[26] *See supra* Part VI–V (discussing whether oil and gas tax subsidies realize their purposes and if they do not they should be repealed).
[27] *See The World's Biggest Public Companies*, FORBES, (April 2011), http://www.forbes.com/global2000/list/#p_1_s_arank_All_All_All (listing ExxonMobil, Chevron, and ConocoPhillips as three of the top twenty-five largest public companies in the world.)
[28] *See COUNTRY COMPARISON:: POPULATION*, THE WORLD FACTBOOK (Oct. 29, 2010, 4:30 PM), *available at* https://www.cia.gov/library /publications/the-world-factbook/rankorder/2119rank.html; *U.S. Petroleum Supply, Consumption, and Inventories*, ENERGY INFO. ADMIN. (Oct. 29, 2011, 4:42 PM), *available at* http://www.eia.doe.gov/emeu/steo/pub/4atab.pdf; *World Petroleum Consumption*, ENERGY INFO. ADMIN. (Oct. 29, 2011, 4:42 PM), *available at* http://www.eia.doe.gov/emeu/steo/pub/3dtab.pdf; Safe, Strong and Secure: Reducing America's Oil Dependence, NATURAL RES. DEF. COUNCIL (Oct. 29, 2011, 4:42 PM), *available at* http://www.nrdc.org/air/transportation/aoilpolicy2.asp.
[29] *Basics*, THE SELECT COMM. ON ENERGY INDEPENDENCE AND GLOBAL WARMING (Oct. 29, 2011, 4:45 PM), *available at* http://globalwarming.house.gov/issues/energyindependence?id=0002.
[30] Zarroll, *supra* note 7.

reaches a new record in 2012[31] and domestic oil output reached its highest annual output since 2003.[32] These factors surmise that the oil and gas industry continues to make an impact, not only domestically, but internationally as well.

Another way that oil companies make an impact is through large political contributors.[33] For example, from 1991 to 1996, the oil and gas industry collectively donated over $50 million to the U.S. federal elections, mostly to Republican representatives.[34] This suggests that an obstacle to the repeal of certain oil and gas subsidies could be the industry's strong political clout.[35]The oil and gas industry is notoriously powerful and influential[36] – overcoming their political influence is potentially the greater challenge in repealing these tax subsidies.[37]

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[31] *US oil and gas M&A jumps in 2011,* BLOOMBERG BUSINESSWEEK (Feb. 8, 2012, 4:03 PM), http://www.businessweek.com/ap/financialnews/D9SPE6500.htm

[32] Some are considering this time period a "great revival" in domestic production. Mason Inman, *U.S. Oil Fields Stage "Great Revival," But No Easing Gas Prices*, NATIONAL GEOGRAPHIC DAILY NEWS (Feb. 10, 2012), http://news.nationalgeographic.com/news/energy/2012/02/120210-us-oil-production-increasing/

[33] Charles Dillon, *Oil Industry Tax Benefits Helping the Environment*, 7 U. BALT. J. ENVTL. L. 46, 47 (1999). *See Executive Summary, Oiling the Machine: Fossil Fuel Dollars Funneled into the US Political Process* (Oct. 27, 2011, 2:17 PM), http://archive.greenpeace.org/climate/kindustry/government/machine.html.

[34] *Id*. As of December 31, 2011, President Obama raised $139.5 million and Mitt Romney, the leading Republican candidate, raised $57,112 for the following presidential campaign. Evan Carmi, et. al. *The 2012 Money Race: Compare the Candidates*, N.Y. TIMES, (Dec. 12, 2012) http://elections.nytimes.com/2012/campaign-finance.

[35] *See supra* note 33 (suggesting that financial support for candidates increases industry support for favorable tax treatment, politically).

[36] *See generally* Peter Gardett, *Energy Voters as a Political Power*, THE HUFFINGTON POST, (Jan. 10, 2012, 2:25 PM) http://www.huffingtonpost.com/peter-gardett/energy-voters-as-a-politi_b_1192646.html (predicting that the Obama Administration's decision regarding the Keystone Pipelines carries great political clout).

[37] *See supra* note 33 (suggesting that financial support for candidates increases industry support for favorable tax treatment, politically).

III. OIL AND GAS TAX SUBSIDIES

This section provides a brief introduction to the ten most common oil and gas tax subsidies. Each tax subsidy consists of many elements and rules, but only the ones relevant to the arguments regarding its repeal are discussed.

A. *Percentage Depletion*

Percentage depletion is perhaps one of the "most . . . cited subsidies for oil and gas production."[38] It allows independent producers,[39] including individual investors, to deduct a flat percentage of the gross income produced by a well.[40] This is due to the naturally depleting nature of the oil or gas.[41]

The statute was meant to reflect the recovery of the capital investment in the well.[42] But the percentage depletion benefit continues on, even after the full investment in the well is recovered.[43] Additionally, the percentage depletion deduction increases as the commodity price increases because percentage deduction is calculated against the product's gross income, as opposed to its cost or production.[44] Therefore, the deductions can far exceed the project's basis or investment.[45]

Some limitations are placed on this generous subsidy: the statute allows a taxpayer to deduct fifteen percent of his or her gross income, but limits these deductions to one thousand

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[38] Bodgdanski, *supra* note 20, at 325. *See, e.g.*, Mann, *supra* note 5, at 387-86 (parenthetical); Patrick L. O'Daniel, *Muddy Waters in the Pool of Capital:* ZuHone *and the Abolition of the Doctrine*, 70 TEX. L. REV. 243, 251 n.49 (1991).
[39] Zarroll, *supra* note 7.
[40] I.R.C. §§ 611(a), 613(a)-(b), 613(A)(c)(6), 613(A)(c)(1) (2006).
[41] *Id*.
[42] I.R.C. § 611(a); Bodgdanski, *supra* note 20, at 325.
[43] I.R.C. § 611(a); Bodgdanski, *supra* note 20, at 325.
[44] I.R.C. § 611(a) (2006); *See* Starkman, *supra* note 21, at 186.
[45] I.R.C. § 611(a); Bodgdanski, *supra* note 20, at 325.

barrels of product per day and up to sixty-five percent of the taxpayer's net income.[46] Additionally, integrated companies[47] may not take advantage of percentage depletion.[48]They must utilize cost depletion, a method which allows deductions to be taken only when production costs occur, thereby limiting the deductions to costs and not gross income.[49]

The history of the creation of percentage depletion, dating back to 1926, emerged because of the high-risk and "exhaustible" nature of oil and gas extraction.[50] Originally, no distinctions were made between the lone "black-gold" seeker[51] and the Rockefeller-type investors.[52] Then, following the 1973 Arab Oil Embargo, in 1975, percentage depletion was reduced from 27.5% to fifteen percent.[53] Additionally, many limitations were placed on the subsidy, including distinguishing integrated companies from non-integrated ones.[54] Since then, this statute has not been revisited.[55] Past fears, to justify this statute, were rooted in expert predictions that oil supplies would last only ten more years.[56] In contrast, during modern times, Congress justified retaining the statute to "protect the prospector or wildcatter who risked

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[46] Cecil, *supra* note 26, at 217.
[47] HOWARD WILLIAMS & CHARLES MEYERS, MANUAL OF OIL & GAS TERMS 367 (5th ed. 1981) (defining integrated oil and gas companies as companies which are "engaged in all phrases of the oil [and gas] industry, from exploration for oil [and gas] deposits to retail sale of oil [and gas] products").
[48] Cecil, *supra* note 26, at 217.
[49] Bodgdanski, *supra* note 20, at 325. As opposed to percentage depletion, which can continue to benefit the taxpayer even after all their costs have been deducted. I.R.C. § 611(a); Bodgdanski, *supra* note 19, at 325.
[50] OWEN L. ANDERSON, ET. AL, HEMINGWAY OIL AND GAS LAW AND TAXATION 635 (4th ed. 2004); Bodgdanski, *supra* note 20, at 325.
[51] *See* Starkman, *supra* note 21, at 186 (contrasting the different types of oil and gas drillers as "the adventurer and Standard Oil's John D. Rockefeller").
[52] *Id*.
[53] Starkman, *supra* note 21, at 186; JOHN S. LOWE, ET. AL, CASES AND MATERIALS ON OIL AND GAS LAW 332 (5th ed. 2008).
[54] LOWE, *supra* note 56, at 332.
[55] Starkman, *supra* note 21, at 186.
[56] *Id*.

drilling in unknown territory."[57] And correctly, many of the holes that were drilled as recently as fifty years ago, were dry.[58]

B. *Intangible Drilling Costs (IDCs)*

Intangible drilling costs are any costs generally related to drilling a well that cannot recover a salvage value.[59] Examples of such expenditures are costs related to labor, fuel, power, materials, supplies, tool rentals and repairs associated with drilling, and equipping productive wells.[60] The deductions may also be applied towards the intangible costs of drilling exploratory wells, if those wells also might produce oil or gas.[61]

Generally, section 263 of the Tax Code allows integrated oil companies to immediately deduct seventy percent of their IDCs, and independent oil producers[62] can deduct one hundred percent of their IDCs.[63] The remaining thirty percent of the IDCs that integrated oil companies cannot immediately deduct are amortized over a sixty-month period or more.[64]In addition, taxpayers can choose to bypass these deductions and amortize all their IDCs instead.[65] However, this advantage is not utilized often, as most oil and gas companies will choose to deduct their

[57] *Id*.
[58] *Id*. It is interesting to note that percentage depletion began as a subsidy specifically for oil and gas production due to its depletable nature, yet this subsidy was not offered to other depletable minerals, such as coal. *Id*. at 193.
[59] ANDERSON, ET. AL, *supra* note 50, at 546. Salvage value is "the amount expected to be obtained when a fixed asset is disposed of at the end of its useful life. BLACK'S LAW DICTIONARY 743 (2nd Pocket ed. 2001).
[60] STEPHEN L. MCDONALD, FEDERAL TAX TREATMENT OF INCOME FROM OIL AND GAS 10 (1963); I.R.C. § 1.612-4(c)(2) (West 2006).
[61] I.R.C. § 1.612(4)(a), (c)(1) (2006).
[62] *Id*. at 356 (defining independent oil companies as companies that are "(1) [a] purely domestic organization not dependent on foreign oil; (2) A company or individual whose actual management and financial source are substantially the same; (3) A person who produces oil and gas and is not engaged in transportation, refining or marketing of such products").
[63] I.R.C. § 263(c) (2006); I.R.C. § 291(b)(1) (2006); Treas. Reg. § 1.612-4 (2010).
[64] I.R.C. § 291(b)(1)-(2) (2006); Rev. Rul. 93-26, 1993-1 C.B. 50, 51.
[65] *See* I.R.C §§ 55(b)(2), 59(e) (2006).

IDCs expenses.[66] Coincidentally, deducting costs means that the gain on a sale or exchange of the well property will be taxed as ordinary income, not capital gain.[67]

The primary purposes for the intangible drilling costs tax deduction, as explained by Congress in 1954, was because it was "in the public interest"[68] and affirmed the Treasury's percentage depletion provision.[69] The historical reasoning behind the decision to allow IDC deductions is ambiguous.[70] Thus far, not much has changed, as the current motivation behind IDC deduction continuation is still "completely rooted in the public policy of an industry incentive."[71]

C. *Domestic Manufacturing Activity*

The manufacturing tax deduction allows a reduction in the income tax rate "equal to a percentage of the lesser of taxable income or income from domestic 'production' activities."[72] Manufacturing activity includes activity such as manufacturing, production, and extraction, including architecture, engineering, movies, and construction.[73] Activities involving "selling" a product do not qualify for the deduction.[74] And, unlike other domestic manufacturing industries

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[66] Cecil, *supra* note 24, at 212, 219.
[67] This is so taxpayers do not receive a double benefit by receiving a more favorable tax rate (usually a capital gains rate) and deduction benefits. I.R.C. § 1254 (2006). Generally, capital gain is taxed at a lesser (more advantageous) rate than ordinary income. MCDONALD, *supra* note 60, at 540.
[68] ANDERSON, ET. AL, *supra* note 50, at 545; H.R. Con. Res. 50, 79th Cong., 1st Sess., 59 Stat. 844 (1945).
[69] Starkman, *supra* note 21, at 189 (2011). *See* supra Part III.A (explaining the percentage depletion tax subsidy for oil and gas wells).
[70] ANDERSON, ET. AL, *supra* note 50, at 545–46.
[71] *Id*. This purpose is similar to Congress' "public interest" purpose behind the IDC deduction in 1954. ANDERSON, ET. AL, *supra* note 50, at 545; H.R. Con. Res. 50, 79th Cong., 1st Sess., 59 Stat. 844 (1945).
[72] Bodgdanski, *supra* note 20, at 327.
[73] GRAETZ & SCHENK, *supra* note 3, at 254.
[74] *Id*. What qualifies as "selling" activities may be confusing. For example, roasting coffee beans sometimes qualifies as manufacturing and sometimes does not. *Id*.

Back to Table of Contents

whose tax income rates are essentially reduced by nine percent, oil and gas tax rates are reduced by six percent.[75]

Some restrictions to the domestic manufacturing subsidy are that deductions are limited to fifty percent of the domestic wages paid by the taxpayer and allocable to the income that makes up the base of the deduction.[76] Even so, the deduction is a great advantage to oil and gas companies involved in the activities of extraction and production.[77] In fact, the combination of many of these deductions might even lead to a negative income tax.[78]

Originally, the manufacturing tax deduction was created to encourage production and manufacturing activities that was domestically "manufactured, produced, grown or *extracted*."[79] Interestingly, oil and gas activities were only recently categorized as a manufacturing industry in the 2004 American Jobs Creation Act.[80] And, under that Act, oil and gas companies were able to incorporate phased in reductions of extraction costs over the next several years.[81]

D. *Geological and Geophysical Expenses*

Geological[82] and geophysical[83] research expensed by non-integrated companies is amortized over a two-year period.[84] Integrated companies grossing over one billion dollars

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[75] I.R.C. § 199(a)(1); I.R.C. § 199(d)(9) (Supp. II 2009).
[76] I.R.C. § 199(d) (2006).
[77] I.R.C. §§ 613A(d)(2)–(4) (2006); *see, e.g.*, Calvin H. Johnson, *Accurate and Honest Tax Accounting for Oil and Gas*, 125 TAX NOTES 573, 577 (2009) (displaying examples of oil and gas companies that may pay combine some of these subsidies to result in a negative tax).
[78] *Id*. Negative income tax is "a system of income subsidy through which persons having less than a certain annual income receive money from the government rather than pay taxes to it." *Negative Income Tax Definition*, DICTIONARY.COM, http://dictionary.reference.com/browse/negative+income+tax (last visited Feb. 13, 2012).
[79] I.R.C § 199(d) (2006); GRAETZ & SCHENK, *supra* note 3, at 254.
[80] American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 102, 118 Stat. 1418, 1525-29.
[81] Robert Pirog, CONG. RESEARCH SERV., R40715, *Oil Industry Tax Issues and Deficient Issues*, 4, 6 (2009) [Hereafter "Pirog, R40715"]; Cecil, *supra* note 24, at 219.
[82] *See* ANDERSON, ET. AL, *supra* note 50, at 534 ("Geological costs are those exploratory costs that relate to the study of the geology of the surface and subsurface. They include a study of

amortize those costs over seven years.[85] This provision is especially helpful to taxpayers utilizing percentage depletion because the percentage depletion subsidy is based on a percentage of the taxpayer's overall revenue.[86] If these costs could not be amortized over two years and were included in the basis of the well, many of the advantages of percentage depletion would be completely lost.[87]

Before 1941, geological and geophysical expenses were analogous to other research expenses and deducted as an ordinary and necessary business expense, deductible in the year paid or incurred.[88] Then in 1946, the tax court in *Louisiana Land & Exploration v. Commissioner* decided that geo-research activities do not distinguish themselves from activities such as "plating, mapping, and subdividing [] a tract of land."[89] Therefore, geological and geophysical expenses should be similarly capitalized.[90]

Note that section 615 and section 617 of the Tax Code refer to the overall treatment of mineral exploration but do not specifically address oil and gas exploration.[91] In fact, no tax provision addresses the treatment of geophysical and geological costs related to oil and gas exploration.[92]

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surface outcropping and anomalies, core samples from slim holes drilled at shallow depths, core samples from other wells in the vicinity, and interpolation of the information with other such information from the vicinity."). *La. Land & Explor'n v. Comm'r*, 7 T.C. 507, 510 (1946).

[83] *See* ANDERSON, ET. AL, *supra* note 50, at 534 ("Geophysical costs result from seismic surveys, gravity and magnetic surveys, electrical resistance, and intensity studies."); *see also id.* at 534 (listing legally defined geophysical activities).

[84] I.R.C. § 167(h)(5) (2010).

[85] *Id*.

[86] Bodgdanski, *supra* note 20, at 326; *see infra* Part V.B (describing the advantages of the percentage depletion tax subsidy).

[87] Bodgdanski, *supra* note 20, at 326.

[88] Frank Burke, Jr. *Current Expensing of Geological and Geophysical Costs: A Need for Legislative Clarification*, 34 OKLA. L. REV. 778, 780 (1981).

[89] *Louisiana Land & Exploration v. Comm'r*, 7 T.C. 507, 510 (1946).

[90] *Id*. at 516.

[91] I.R.C. §§ 615, 617 (2006); ANDERSON, ET. AL, *supra* note 50, at 534.

[92] I.R.C. §§ 615, 617 ; ANDERSON, ET. AL, *supra* note 50, at 534.

Back to Table of Contents

E. *Passive Loss Exceptions For Working Interests*

Normally, investors who do not materially and actively manage their investments are considered "passive" investors.[93] Passive investors are only entitled to deduct passive losses from the corresponding passive gains.[94] This rule was enacted in 1986[95] to prevent beneficial loss deductions from primarily tax shelter-type investments.[96]

However, taxpayers who might otherwise be considered passive investors can bypass those rules if they have a "working interest" in oil and gas wells.[97] A working interest is a "burden in the cost of development and operation of the property."[98] More specifically, one qualifies as a working interest owner if they typically: (1) are kept informed of operations; (2) have a proportionate share in voting rights regarding the property; (3) have responsibility for signing authorizations for expenditure; (4) have the option to continue operations if the current operator ceases; (5) are subject to proportionate tort liability; and (6) bear at least some responsibility for future costs related to the property.[99] If these requirements are met, persons who do not actively manage their property are still eligible to participate in the tax shelter.[100]

F. Deductions for Tertiary Injections

Tertiary injections are regularly utilized to encourage output from older wells.[101] Usually, expenses incurred towards profit-creating activity, such as tertiary injections, are capitalized.[102]

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[93] I.R.C. § 469 (2006); GRAETZ & SCHENK, *supra* note 3, at 415.
[94] I.R.C. § 469 (2006); GRAETZ & SCHENK, *supra* note 3, at 415.
[95] ANDERSON, ET. AL, *supra* note 50, at 534.
[96] GRAETZ & SCHENK, *supra* note 3, at 414.
[97] I.R.C. § 469(c)(3) (2006); Bodgdanski, *supra* note 20, at 327.
[98] ANDERSON, ET. AL, *supra* note 50, at 534.
[99] S. REP. NO. 99-313, at 744 (1986).
[100] Bodgdanski, *supra* note 20, at 327.
[101] *See* Pirog R40715, *supra* note 76, at 4 (parenthetical).
[102] GRAETZ & SCHENK, *supra* note 3, at 311.

However, § 193 allows tertiary injection expenses to be deducted.[103] This is permitted even if the taxpayer did not elect to deduct intangible drilling costs.[104] One limitation to this deduction involves the use of recoverable hydrocarbons.[105] If more than an "insignificant" amount of hydrocarbons is used, one can only deduct the lower of the cost of injecting the hydrocarbons, or the market value of the hydrocarbon.[106]

Additionally, a tax credit is available for injection expenses and for production from marginal wells.[107] However, these benefits do not come into play unless oil and gas prices are far below current prices.[108] Therefore these benefits have not been utilized for quite some time.[109]

G. *LIFO Inventory Accounting*

Last In First Out (LIFO) inventory accounting allows taxpayers to record their most recently acquired products as the first ones sold.[110] This is in contrast to the First In First Out (FIFO) accounting method, which is internationally utilized and has generally replaced LIFO.[111] While other industries are commonly required to use FIFO,[112] some oil and gas companies are permitted to utilize LIFO.[113] In that case, as oil and gas prices rise, LIFO

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103 *See* JOINT COMM. ON TAXATION, 111TH CONG., OIL AND GAS TAX PROVISIONS: A CONSIDERATION OF THE PRESIDENT'S FISCAL YEAR 2010 BUDGET PROPOSAL 21-22 (2009) (containing a chart of the major legislation regarding oil and gas tax since 1969).
104 I.R.C. § 193(a) (2006); Bodgdanski, *supra* note 20, at 326; *see supra* Part II.B (noting that one can elect to utilize IDCs or not).
105 I.R.C. §§ 43(a), (c)(1)(C) (West 2006).
106 I.R.C. §§ 43(a), (c)(1)(C) (2006).
107 I.R.C. §§ 43(b), 451(b)(2) (2006).
108 I.R.C §§ 451, 469(c)(3) (2006).
109 Starkman, *supra* note 21, at 189.
110 I.R.C. § 472 (2006); Bodgdanski, *supra* note 19, at 325.
111 Sharda Sharma, *The Impact of the Adoption of International Financial Reporting Standards on the Legal Profession*, 10 HOUS. BUS. & TAX L.J. 139, 158 (2010); *see also* Lee A. Sheppard, *Cash on the Barrelhead: BP and Taxes*, 128 TAX NOTES 571, 576 (2010).
112 Sharma, *supra* note 91, at PIN; Sheppard, *supra* note 91, at PIN.
113 I.R.C. § 472 (2006); Bodgdanski, *supra* note 19, at 325.

Back to Table of Contents

inventory accounting allows oil and gas companies to substantially reduce their taxable income.[114]

H. *Pool of Capital Doctrine and Carried Interests*

Drilling companies may choose to reward landowners, drillers, and suppliers with economic interests in the future profits of the operations as opposed to payment for services.[115] Transfers of this sort are not treated as taxable income to either side of the transaction due to the pool of capital doctrine.[116] Neither is this transaction taxable under the general concept of partnership interest (otherwise known as "carried interests").[117] This type of benefit is considered a tax subsidy because in-kind exchanges should be recognized on income statements.[118] Yet, in this case, neither party recognizes this exchange on their income statements.[119]

I. *Credit for Enhanced Oil Recovery Costs*

This credit allows taxpayers to claim a tax credit of fifteen percent on certain costs.[120] Some of these costs include intangible drilling and development costs, tertiary injection expenses, costs from certain Alaskan natural gas facilities, and amounts paid for depreciable tangible property.[121] This subsidy is currently not utilized because it is phased out when barrels are priced above $41.[122]

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[114] Bodgdanski, *supra* note 20, at 325.
[115] Johnson, *supra* note 77, at 574.
[116] *See, e.g.*, Rev. Rul. 77-176, 1977-1 C.B. 77, 78.
[117] Rev. Proc. 2001-43, 2001-2 C.B. 191, 191; I.R.S. Notice 2005-43, 2005-1 C.B. 1221, 1224.
[118] GRAETZ & SCHENK, *supra* note 3, at 103.
[119] Bodgdanski, *supra* note 20, at 328.
[120] I.R.C. § 43 (2006).
[121] *Id.*
[122] Johnson, *supra* note 77, at 583.

Back to Table of Contents

J. *Marginal Well Tax Credit*

Added to the Code in 1994, this tax credit provides a minimal credit for oil and gas produced[123]. This provision was created to provide a "safety net for marginal wells during period of low prices."[124] However, this benefit is only available to producers with a daily production of twenty-five barrels or less.[125]

IV. GENERAL ECONOMIC AND ENVIRONMENT CONSIDERATIONS IN REPEALING SUBSIDIES

One of the criticisms towards tax subsidies is that they encourage inefficient consumption.[126] This is because subsidies distort the true economical value of investment, exploration, and consumption by misrepresenting its actual worth.[127] In other words, taxpayers could make poor consumption choices because the tax system has caused a cost to become "overvalued."[128] This is because tax subsidies can "lead to an over allocation of resources to the tax-favored industries and an under allocation of resources to other industries."[129] In some

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[123] I.R.C. §451(b)(1) (West 2006).
[124] OIL AND GAS TAX PROVISIONS: A CONSIDERATION OF THE PRESIDENT'S FY 2010 BUDGE PROPOSAL: HEARING BEFORE THE SUBCOMM. ON ENERGY, NATURAL RESOURCES AND INFRASTRUCTURE OF THE S. COMM. ON FINANCE, 111TH CONG. 2, 7 (2009) (statement of Alan B. Krueger, Assistant Secretary for Economic Policy and Chief Economist, United States Department of the Treasury).
[125] I.R.C. §613(A)(c)(6) (West 2006).
[126] *See* Janet Sterns, *Low-Income Housing Tax Credit: A Poor Solution to the Housing Crisis*, 6 YALE L. & POL'Y REV. 203, 205 (1988) (suggesting that tax credits for low-income housing leads to inefficient policy); JOSHUA D. ROSENBERG & DOMINIC L. DAHER, THE LAW OF FEDERAL INCOME TAXATION PRINCIPLES AND POLICIES 18 (6th ed. 2008) (discussing that one of the main issues of tax is fairness and equality in it's general application).
[127] Johnson, *supra* note 77, at 577.
[128] *Id*.
[129] Letter from Kim Wallace, Assistant Secretary for Legislative Affairs, to Honorable Lynn Jenkins, U.S. House of Representatives (Apr. 21, 2010) (on file with West Law online database) [hereafter "Letter from Kim Wallace"].

instances, tax subsidies serve as a social or moral cause, such as subsidies towards housing[130] and healthcare[131]. Those are often seen as an integral part of supporting humanity (one needs shelter and minimal healthcare to survive) and therefore often justified.[132] In fact, oil and gas subsidies do provide some forms of livelihood, including nine million jobs, mineral resources, and industry.[133] However, it is most likely that without tax subsidies, the economic benefits derived from oil and gas will continue.[134] Oil and gas is already viewed as an extremely affluent industry.[135] For example, the three largest oil and gas companies—Shell, Chevron, and Conoco Phillips—made combined profits of over $60 billion in one year.[136] This forces a reevaluation of how much industry support is needed, or should be warranted from tax subsidies.[137]

Originally, many of the tax subsidies for oil and gas industries were constructed under the rationale that the industry needed protection during times of low prices to maintain national energy security.[138] This rationale no longer stands, as oil and gas prices have risen to the point where price alone drives industry growth.[139] In fact, talk of repeals has been ongoing since the

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[130] JOINT COMM. ON TAXATION, *supra* note 2, at 9.
[131] *Id.*
[132] *See* GRAETZ, *supra* note 3, at 53-54 (explaining that social spending types of subsidies, such as for housing and healthcare, are meant to induce a certain type of behavior that is unrelated to business spending, but "geared towards income support for retirement").
[133] Zarroll, *supra* note 7.
[134] *See* Johnson, *supra* note 77, at 574 (stating that the "price of oil provides a sufficient free-market incentive to explore for and extract oil and gas . . . in every case").
[135] *See supra* note 27 (displaying ExxonMobil's profits at $30.5 billion, Chevron's profits at $19 billion, and ConocoPhillip's profits at $11.4 billion).
[136] Id. Note that other "bigger" U.S. publicly listed companies, such as JPMorgan Chase and General Electric, only make profits of $17.4 billion and $11.6 billion, respectively, which is much less than Shell and Chevron's profits. *Id.*
[137] Zarroll, *supra* note 7.
[138] *See* OIL AND GAS TAX PROVISIONS, *supra* note 124, at 2 (statement of Stephen Brown, Nonresident Fellow, Resources for the Future) (parenthetical).
[139] Cecil, *supra* note 24, at 221.

Back to Table of Contents

1940s and is not a novel consideration by the Obama Administration.[140] But currently, motivation for future federal budget proposals is fueled by an incentive to build up the country's alternative energy industry while eliminating dependence on foreign oil.[141]

As stated, one of the reasons for reexamining these oil and gas tax subsidies is to incentivize investment in alternative energy investment.[142] This has been reiterated multiple times as talks continue regarding the repeal of oil and gas tax subsidies.[143] One of the major reasons why there is so much attention on alternative energy is because it serves to lessen global warming, decrease dependence on foreign oil, and lower energy costs.[144] But, because of the

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[140] *Id.* at 215; *see* JOINT COMM. ON TAXATION, 111TH(((superscripted? check globally))) CONG., OIL AND GAS TAX PROVISIONS: A CONSIDERATION OF THE PRESIDENT'S FISCAL YEAR 2010 BUDGET PROPOSAL, at 21-22 (containing a chart of the major legislation regarding oil and gas tax since 1969; *see also* J.P. Jackson, *Federal Income Tax Percentage Depletion of Oil and Gas Wells–Another View,* 6 Tex. L. Rev. 798, 799 (1943) (describing the effort to repeal the percentage depletion oil and gas subsidy in 1942 in front of the Ways and Means Committee of the House of Representatives).

[141] STAFF OF H. COMM. ON THE BUDGET, 111TH CONG., SUMMARY OF THE PRESIDENT'S FISCAL YEAR 2010 BUDGET, at 2.

[142] *Id.*; *see* Robert Pirog, CONG. RESEARCH SERV., R41139, Oil Industry Tax Issues in the Fiscal Year, 1 (2011) [hereafter, "Pirog, R41139"](((make sure your formatting is consistent throughout))) (recalling Obama's 2009 Earth Day speech which emphasizes the importance in developing technology for alternative energy to lower the country's dependence on foreign oil).

[143] *Id. See, e.g.*, Christoper Riti, *Three Sheets to the Wind: The Renewable Energy Production Tax Credit, Congressional Political Posturing, and an Unstable Energy Policy*, 27 PACE ENVTL. L. REV. 783, 809 (2010) ("Many of the conventional energy industries had had the decades-long endorsement and financial backing of the federal government . . . with these considerations in mind, there is no escaping the fact that to adequately fund the PTC, Congress must repeal part of all of those subsidies currently available that qualify, in effect, as handouts to matured industries."); *see also* Letter from Kim Wallace, *supra* note 129 ("The current set of tax subsidies for oil and gas production also work against the goals of reducing the negative externalities associated with oil and gas production and transitioning to cleaner energy sources.").

[144] *See generally Benefits of Renewable Energy Use*, UNION OF CONCERNED SCIENTISTS: CITIZENS AND SCIENTISTS FOR ENVIRONMENTAL SOLUTIONS, (Jan. 12, 2012, 8:26 PM), http://www.ucsusa.org/clean_energy/technology_and_impacts/impacts/public-benefits-of-renewable.html. Many of the benefits of alternative energy meet the goals of that oil and gas tax subsidies were designed to meet. *See* supra Part II, note 141 and accompanying text, note 145 and accompanying text (juxtaposing Congress's goals to attain energy independence, security,

capital-intensive nature and delayed returns associated with clean energy projects, many are reluctant to invest.[145] The industry may even be in a "stall" due to the lack of financial support.[146]

Oil and gas tax subsidies also exacerbate this issue in two additional ways: first, the investment in oil and gas is over encouraged, and second, oil and gas consumption prices are understated.[147] In addition, creating more incentive to invest in oil and gas than alternative energy basically encourages pollution.[148] This path will ultimately lead to society sharing a burden of billions of dollars, as taxpayers and government must eventually address the pollution caused by the fossil fuel era.[149] This is especially true, as that fossil fuel era is projected to continue into the next sixty years.[150] So while investment in alternative energy is already severely handicapped by the long-term return and high-risk nature of the investment,[151] current oil and gas tax subsidies cause even greater disparity between the two choices.[152]

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and low prices, against those of Congress' goals regarding the development of alternative energy).

[145] Riti, *supra* note 112, at 786.

[146] *See* Denis Hayes, *Solar and Wind Power Held Hostage—Again*, YALE ENV'T 360 (Oct. 29, 2011, 4:56PM), http://e360.yale.edu/feature/solar_and_wind_power_held_hostage_again/2060/ (concluding there is a "stall" in the alternative energy industry perpetuated by a lack of investment).

[147] Riti, *supra* note 112, at 787; *see* Letter from Kim Wallace, *supra* note 129 (stating that oil and gas prices do not convey the cost of environmental harm from greenhouse gases through its consumption and that spending choices are distorted due to the favoring affect of subsidies).

[148] Douglas Koplow & Aaron Martin, *Fueling Global Warming: Federal Subsidies to Oil in the United States* (Oct. 27, 2011, 2:41 PM), http://archive.greenpeace.org/climate/oil/fdsuboil.pdf.

[149] *Id*.

[150] *See* Clifford Krauss, *New Technologies Redraw the World's Energy Picture*, N.Y. TIMES, (Oct. 25, 2011), http://www.nytimes.com/2011/10/26/business/energy-environment/new-technologies-redraw-the-worlds-energy-picture.html ("[T]he fossil fuel age will be extended for decades . . . unconventional oil and gas are at the beginning of a technology cycle that can last 60 years.").

[151] Riti, *supra* note 112, at 786.

[152] *See* Letter from Kim Wallace, *supra* note 129 (reiterating that spending choices are distorted due to the favoring affect of oil and gas subsidies).

It is also important to point out that greater investment in alternative energy means less dependence on foreign oil, a positive consequence of repealing these tax subsidies.[153] But, just as easily, these repeals could result in negative effects.[154] For example, investors could choose to place their money in other "tried and true" fossil fuels, or anywhere else of their choosing.[155] After all, repealing oil and gas tax subsidies does not automatically make investing in alternative energy a more attractive option.[156] To resolve this issue, the federal government could place the revenue from the additional oil and gas taxes directly into supporting alternative energy.[157] On the other hand, because the alterative energy industry already has its own tax incentives for investment,[158] the repeal may sufficiently serve its purpose by merely balancing the energy "playing field."[159]

The main reason for repealing tax subsidies is to create revenue for the government.[160] All negative effects from the repeal should be weighed against the positive effects of additional

[153] *See Benefits of Renewable Energy Use*, *supra* note 144 (dependence on foreign oil leaves America vulnerable to fuel price shocks or shortages).
[154] *See* Pirog, R41139, *supra* note 142, at 6 (exploring the negative effect of oil and gas tax subsidy repeals, as "tax changes . . . [could increase] the nation's foreign oil dependence").
[155] *See* Bodgdanski, *supra* note 20, at 333 ("If capital is pulled out of oil and gas, it may be redirected to industries that are no less harmful to the environment.").
[156] *See id*. ("[I]t is not clear that eliminating them would stimulate interest in alternative energy sources, any more than it would stimulate interest in completely different types of investments.").
[157] Bodgdanski, *supra* note 20, at 336.
[158] *See* Mann, *supra* note 5, at 386 ("[R]enewable energy enjoys federal tax benefits primarily through the production tax credit (PTC) and the investment tax credit (ITC)."); I.R.C. § 45 (2009) (ITC provides a tax credit of 30 percent of the project cost for "energy property"); *id.* at § 48 (PTC reduces tax liability over a ten year period after the project beings producing electricity based on the amount of electricity produced, rather than on the cost of the property).
[159] *See* Riti, *supra* note 112, at 786 (arguing that in order to sustain alternative energy tax credits, oil and gas tax subsidies must be repealed).
[160] *See* Cecil, *supra* note 24, at 211 ("The effect of the repeal of these tax incentives is estimated to be almost $36 billion in tax revenue over the next ten years).

Back to Table of Contents

revenue for the government.[161] The amount of revenue is questionable – although the tax subsidies create tax expenditures of $32.3 billion over the past four years,[162] the revenue created by a repeal of these subsidies will not generate exactly $32.3 billion.[163] This is due to possible changes in investment behavior as a reaction to the tax repeal.[164] In addition, the government will share in some of the potential profit loss that oil and gas companies may experience upon the repeal.[165] Therefore, the projected revenue income is uncertain, but some predict these repeals will result in an additional $18.2 billion in revenue over the next four years,[166] or $36 billion in revenue over the next ten years.[167]

There are arguments that $32.3 billion is too insignificant to justify repealing numerous oil and gas subsidies, as the benefit is basically the equivalent of the brief but effective "cash for clunkers" automobile subsidy program.[168] And, these tax expenditures amount to less than one-

[161] *Id*.
[162] *See supra* Part I (nothing that amount of tax expenditures created through oil and gas subsidies).
[163] *See infra* note 167 (explaining why tax expenditure calculations do not equal the amount of federal revenue gained upon the repeal of that tax subsidy).
[164] *See* JOINT COMM. ON TAXATION, *supra* note 2, at 5 (explaining that tax expenditure calculations cannot be compared directly with projected revenues – the two are not the same because "actual repeal would have behavioral consequences that would affect post-repeal revenue collections").
[165] *See* Livingston, *supra* note 1, at 183 (suggesting that according to the Domer-Musgrave model, risk-taking can be offset by federal income tax loss deductions, instead of immediate deductions); James Tobin, *Liquidity Preference as Behavior Toward Risk*, 25 REV. ECON. STUD. 65, 70 (1958) (applying an expected utility, indifference curve analysis proof to demonstrate that taxing a full loss offset can result in increased social or public risk).
[166] Pirog, R41139, *supra* note 142, at Summary; Bodgdanski, *supra* note 20, at 332.
[167] *See* Office of Mgmt. & Budget, Exec. Office of the President, Mid-Session Review, in Budge of the United States Government, Fiscal Year 2010, at 44-45 (2009), available at http://www.gpoaccess.gov/usbudget/fy10/pdf/10msr.pdf (calculating that $35.97 billion will be eliminated from the deficit through the elimination of oil and gas company tax preferences).
[168] Bodgdanski, *supra* note 20, at 332.

tenth of the expenditures generated by housing and health subsidies.[169] While the tax expenditures for housing and health dwarf the tax expenditures for oil and gas, the policies and objectives behind those tax expenditures are more grounded in the social well-being of every American (whether or not these goals are actually met).[170] But, one should compare housing and healthcare subsidies to oil and gas subsidies, which affects primarily one industry and, at least nowadays, seems to make the rich even richer.[171] Eventually, all tax expenditures should be reexamined for their effectiveness and purpose.[172] Oil and gas subsidies, regardless of the marginal amount amongst other tax expenditures, can be easily re-examined due to the limited number of beneficial tax provisions.[173] And, a repeal of these provisions will most likely not result in dire effects and consequences due to the forecasted, continuing, high oil and gas prices.[174]

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[169] *See* GRAETZ, *supra* note 3, at 44 (displaying housing tax expenditures total $430.2 billion and health tax expenditures total $628.5 billion).
[170] *See infra* Part I (explaining the purposes behind health and housing subsidies). Note that the health tax expenditure is also currently scrutinized for its effectiveness and is subject to change if the Obama Administration's healthcare reform is passed. *See generally* Kate Pickert, *Details of Obama's Health Care Plan*, Time (Jan. 13, 9:19PM), http://swampland.time.com/2010/02/22/details-of-obamas-health-care-plan/ (mandating a raised threshold for which plans may be taxed and federal regulation of insurance costs, as an example of a few changes to come).
[171] 171 *See supra* note 27 and accompanying text (displaying ExxonMobil's profits at $30.5 billion, Chevron's profits at $19 billion, and ConocoPhillip's profits at $11.4 billion). *See* Johnson, *supra* note 77, at 574 (inferring that certain subsidies, such as the manufacturing subsidy, are basically "handouts" to oil and gas companies).
[172] *See generally* Starkman *supra* note 21 (arguing that tax subsidies in general, even beyond oil and gas subsidies, should be re-examined and repealed if unnecessary or do not meet their purpose).
[173] *See supra* Part II (listing the ten most popular oil and gas tax subsidies to be repealed).
[174] *See supra* Part III (arguing that demand for oil and gas in itself will sustain the industry past the reap of oil and gas tax subsidies).

Back to Table of Contents

The additional revenue from a repeal could help alternative energy overcome their investment hurdles[175] if at least a portion of the revenue is set-aside for that industry.[176] Or, budget proposals to simultaneously increase taxes for oil and gas companies while providing additional subsidies for alternative energy research could subtly sway investors in the direction of alternative energy.[177]

One additional argument against the repeal of preferential oil and gas tax subsidies is that if oil and gas prices rise, Americans will look to other nations to supply their needs.[178] Thus, the repeal of oil and gas taxes will not decrease oil dependency, but actually increase it.[179] However, as the supply of oil and gas continues to grow in Canada and America,[180] and access to the Arctic supply opens up to America,[181] the picture of global "oil dependency" is changing.[182] Some predict that the global oil and gas trade will evolve from a predominately east-west trade to a north-south trade, thereby changing our negative impressions of what foreign oil dependency really means.[183] This is because dependency on oil from Canada is very different from

[175] *See* Denis Hayes, *Solar and Wind Power Held Hostage—Again*, YALE ENV'T 360 (Oct. 29, 2011, 4:56PM), http://e360.yale.edu/feature/solar_and_wind_power_held_hostage_again/2060/ (illustrating that there is a "stall" in the growth of the alternative energy industry due to a lack of investment).
[176] *See* Bodgdanski, *supra* note 20, at 333 ("the proposed . . . legislation that would have repealed many oil and gas tax subsidies would have used the resulting revenue to establish an alternative energy reserve fund").
[177] *See* Pirog R41139, *supra* note 142, at 6 (forecasting budget proposals to increase oil and gas taxes while increasing subsidies for alternative energy).
[178] *See* Bodgdanski, *supra* note 20, at 333 ("The markets for oil and gas are global, and production that is subject to U.S. taxation makes up but a small percentage of overall supply.")
[179] *Id*.
[180] *See infra* Part IV.D (explaining that the recent increase in supply of oil and gas is largely due to the contributions made by geological and geophysical research).
[181] Krauss, *supra* note 150.
[182] *Id*.
[183] *See id*. (predicting that as the oil supply grows, especially in Canada, the Middle East will trades with China and Canada will trade with the United States.").

Back to Table of Contents

dependency on oil in the Middle East.[184] To illustrate, trading between American and Canada is much more politically stable, economically symbiotic, and less costly.[185] Therefore, older arguments against foreign oil dependency, focusing primarily on the Middle East, no longer hold as much merit today because of the increasing global supply of oil and gas.[186]

IV. THE REPEAL OF SPECIFIC SUBSIDIES

A. Percentage Depletion

The purpose behind percentage depletion is obsolete when it comes to oil and gas because of the "black gold" nature of this natural resource.[187] Regardless of the "depletability" of the resource, oil and gas will still be heavily sought wherever it is found.[188] Therefore, subsidies such as percentage depletion are not required to encourage the industry to extract the resource.[189] The price, demand, and profitability of oil and gas alone, are motivation enough.[190]

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[184] *See id.* (noting that Canada is politically stable).

[185] *See id*. (inferring that trading with Canada is much more stable and dependable than trading with the Middle East). Due to the political stability, increased supply, and lower transport costs. *See id*.

[186] *See generally* Krauss, *supra* note 150 ("[t]he fossil fuel age will be extended for decades").

[187] *See* DANIEL YERGIN, THE PRIZE, 536 (2008)(recanting a well-known oil and gas poem that ends in "oil that is, black gold, Texas tea").

[188] *See* DANIEL YERGIN, The Quest, 161 (2011) ("Even though total world petroleum consumption grew by 25 percent between 1980 and 2000 . . . the demand shock–that hit the world oil market in 2004 . . . propelled consumption upward").

[189] *See* Part IV.A (arguing that percentage depletion is not required, generally because the demand of the product will sustain it's profitability, even beyond the repeal of percentage depletion)

[190] *See* Pirog R41139, *supra* note 142, at 6 (arguing that taxpayers will continue to invest in oil and gas beyond the repeal of percentage depletion because American allows personal ownership of oil and gas, unlike other countries in which the nation government owns the resources).

Another reason that percentage depletion is obsolete is that the current exhaustibility of oil and gas is questionable.[191] For example, recent technological advances have facilitated discovery of new areas of oil and the ability to extract that oil.[192] From the oil sands of Canada to the deep-water reserves in India, and back to the shale rocks of America, what was once thought to be a finite and declining resource is now "at the beginning of a technological cycle . . . in their infancy."[193] And, while some may consider the "depletability" factor as one measured by the amount of oil in each individual oil reserve, historical policy arguments for the subsidy suggested the lawmakers supported this subsidy by questioning the exhaustibility of oil and gas as a whole.[194] Therefore the depletability argument could possible be misapplied.[195] Additionally, percentage depletion is an anomaly amongst tax provisions because it allows deductions past the amount of costs invested.[196]

Arguments against the repeal of percentage depletion state that because percentage depletion only applies to non-integrated companies,[197] the repeal of this tax will destroy the "little man."[198] However, this argument is untenable because the repeal of percentage depletion from integrated companies, while affecting company profits, did not affect oil production

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[191] *See generally* Krauss, *supra* note 150 (arguing that new oil sources, such as oil sands in Canada, and other technological advances puts into serious question the exhaustibility of oil and gas).
[192] *Id.*
[193] *Id.*
[194] *See* Starkman *supra* note 21, at 186 ("It all began with World War I. Dissatisfied with what is perceived to be an onerous tax burden, the oil industry introduced geological experts who warned that our limited supply of oil would be exhausted in 10 years. Congress responded with generous depletion provision.").
[195] *Id.*
[196] Starkman, *supra* note 21, at 190.
[197] *See infra* Part IV.A (noting that the advantages of the percentage depletion subsidy only apply to non-integrated companies).
[198] Cecil, *supra* note 24, at 217.

Back to Table of Contents

volume.[199] That is a strong argument that the repeal of percentage depletion, arguably one of the most advantageous tax subsidies, does not affect investment.[200]

Although the repeal of percentage depletion for integrated companies resulted in minimal consequences, non-integrated companies are different in numerous ways.[201] One cannot fail to point out that non-integrated companies are generally more risk-averse.[202] There are arguments for both sides on whether non-integrated companies may survive the repeal of percentage depletion.[203] But, although severe, one should consider that if a company cannot survive without generous subsidies, then it is not an ideal candidate to continue in that industry.[204] Americans believe that the backbone of America is small businesses because it encourages diversification and creativity.[205] But that might not apply in the oil and gas industry because oil and gas requires significant capital investment and large risks.[206] Additionally, it not longer allows for as much entrepreneurial spirit as it did in the days of the wildcatters.[207]

Ultimately, the repeal of percentage depletion will expose naked profits to investors, allowing them to make accurate choices and not choices based on tax handouts set by the

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[199] *Id.*; Pirog R41139, *supra* note 142, at 6.

[200] Cecil, *supra* note 24, at 217; Pirog R41139, *supra* note 142, at 6.

[201] *See supra* Part III.A and accompanying notes (discussing the distinctions between integrated and non-integrated companies).

[202] Livingston, *supra* note 1, at 173.

[203] *See* Bodgdanski, *supra* note 20, at 334 (arguing that repealing certain subsidies might cause a flight of oil companies to operate abroad); Pirog R41139, *supra* note 142, at 6 (arguing that repealing percentage depletion will not affect non-integrated companies because the repeal did not affect integrated companies).

[204] *See* Livingston, supra note 1 at 174 ([l]arge size may be a prerequisite to taking very large risks, including the introduction of expensive new technologies. These considerations suggest that the government should remain neutral in the struggle between large and small").

[205] *See id*. at 173 (stating that small business are a virtuous and associated with affirmative cultural values).

[206] *Id*.

[207] *See id*. at 174 ("[a]s a general rule, the case for smallness seems strongest in industries that place a premium upon human creativity . . . arguably this is less true for, say, refrigerators or automobiles").

Back to Table of Contents

government.[208] The repeal is also predicted to generate $4.3 billion in revenue over the next four years, and $10 billion over the next decade.[209] This will results in large, much needed, revenue increases to the federal government.[210]

B. Intangible Drilling Costs (IDCs)

The deduction for intangible drilling costs is one of the two most controversial deductions to consider repealing.[211] Overall, IDCs should be repealed because of the circumstances in which this deduction originated.[212] Historically, drilling was considered an extremely high-risk venture because drillers, at high costs, were literally drilling into a black hole.[213] Yet today, that risk has been dramatically decreased due to technological advances, including 3-D seismic imaging and horizontal drilling.[214]Remaining costs associated with the reduced risk can be reasonably offset by capitalization instead of straight deductions.[215]

Repealing this deduction is beneficial to the federal government and non-oil and gas industry as it is estimated that the government will gain an additional $11.6 billion in revenue between 2010 and 2019.[216]

Some tax subsidy supporters speculate that a repeal will lead to job loss and reduce national job security.[217] Others, however, believe that those claims are largely unsupported by

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208 Riti, *supra* note 112, at 809 (relating that the current oil and gas tax subsidies are "in effect . . . handouts to matured industries").
209 Pirog R41139, *supra* note 142, at 6.
210 *Id*.
211 Cecil, *supra* note 24, at 223-24. The other controversial deduction is percentage depletion. *Id*.
212 *Id*.
213 *Id*.
214 *Id*.
215 Cecil, *supra* note 24, at 223-24. *See supra* Part II.B. (this is an option already available to oil and gas companies, although few choose to exercise this option because deduction is much more attractive than capitalization).
216 *See* OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, TERMINATIONS, REDUCTIONS, AND SAVINGS, IN BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2010, at 47 (2010), *available at* http://www.gpoaccess.gov/usbudget/fy11/pdf/trs.pdf.

empirical evidence.[218] In fact, there has been little, or even no, empirical evidence presented regarding how much profit or jobs might be lost by a repeal of this tax subsidy.[219] Data such as this would be helpful in assessing actual damages that might be caused by the repeal, instead of purely speculating that damages.

Naturally, in order to fairly accommodate a deduction that has existed for a century,[220] these changes should be instituted gradually.[221] For example, changes can be implemented through early communication of any upcoming repeals and then the repeal can be instigated through phases.[222] Or, the requirements of what constitutes a non-integrated company can continually become more restrictive, until the category is basically irrelevant.[223] Eventually, after gradual implementation of the repeal, the IDC repeal can be completed.

C. Domestic Manufacturing Activity

The tax subsidy for Domestic Manufacturing Activity has been largely utilized to support the declining American industry of manufacturing.[224] The policy behind the tax subsidy for domestic manufacturing activity was to increase domestic jobs.[225] Yet, while manufacturing in America has continued to decline in activity and profit, oil and gas companies are experiencing

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217 *See* OIL AND GAS TAX PROVISIONS, *supra* note 124 (statement of Buddy Kleemier, Chairman, Independent Petroleum Association of America) (parenthetical).
218 Cecil, *supra* note 24, at 219 (stating that most objections regarding stated job loss and economic downturn consequences due to the repeal of tax subsidies are mere "puffery").
219 *See e.g., id* (inferring that the consequences job loss and economic downturn upon the repeal of the oil and gas tax subsidy is mere speculation).
220 *See supra* Part II.B (noting that percentage depletion has existed since 1918).
221 *See* Cecil, *supra* note 24, at 226 ("Although the industry as a whole is unlikely to be affected . . . smaller oil and gas companies may struggle if the repeal of intangible drilling cost deductions and percentage depletion are enacted too quickly").
222 *See id*. (applying the idea of implementing changes through phases to the definition of non-integrated companies).
223 *See supra* Part II.B (describing what constitutes an non-integrated oil and gas company).
224 Pirog R40715, *supra* note 76, at 4.
225 Pirog R41139, *supra* note 142, at 4.

record-high profits.[226] Arguments against repealing this subsidy state that investment capital will decrease, causing detriment to the American economy and national security.[227] However, this argument is untenable because oil and gas companies are continuing to prevail, especially as prices remain consistently high.[228]

Another argument for repealing the domestic manufacturing subsidy for oil and gas is that domestic production of oil and gas is much more advantageous than some other types of manufacturing because of the high cost of transportation associated with importing oil and gas.[229] The transportation cost of importing oil includes not only the physical cost of transportation, but also the costs associated with political uncertainty,[230] terrorism,[231] and even natural disasters.[232] The positive advantages of the "safe" nature of domestic manufacturing, or extracting, of oil far outweigh the six percent benefit derived from the subsidy.[233] Therefore, there is little fear of a decrease in domestic production due to the repeal of this tax subsidy.[234]

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[226] *Id*. at 4-5; Pirog R40715, *supra* note 76, at 4.
[227] OIL AND GAS TAX PROVISIONS, *supra* note *124*, at 2 (statement of Alan B. Krueger, Assistant Secretary for Economic Policy and Chief Economist, United States Department of the Treasury).
[228] *See supra* note 226 and accompanying text (noting that high oil and gas prices mean that domestic manufacturing subsidies do not affect domestic investment).
[229] *See* Jim Efstathiou, Keystone Pipeline Backers Press Obama for Decision in Week, BLOOMBERG BUSINESSWEEK, (Jan. 12, 2012, 11:36AM) http://www.businessweek.com/news/2012-01-12/keystone-pipeline-backers-press-obama-for-decision-in-week.html (investing the affect of the political tension between Iran and America on energy security); Institute for the Analysis of Global Security, *Threat to Oil Transport*, (Jan. 12, 2011, 2:11PM) http://www.iags.org/oiltransport.html (suggesting that factors such as terrorism lead to increased risk of energy supply, and thereby increased cost of transporting oil).
[230] *See* Efstathiou, *supra* note 193 (arguing that the rise of political unrest between Iran and America worries Americans about the cost of oil).
[231] Institute for the Analysis of Global Security, *Threat to Oil Transport*, http://www.iags.org/oiltransport.html (last visited Jan. 16, 2012) (suggesting that factors such as terrorism lead to increased risk of energy supply, and thereby increased cost of transporting oil).
[232] *See* Knowledge@Wharton, *Crude Reality: Why High Oil Prices Are Here to Stay*, (Mar. 16, 2011), http://knowledge.wharton.upenn.edu/article.cfm?articleid=2732.
[233] *See supra* Part V.C (arguing for the repeal of the domestic manufacturing subsidy).
[234] *Id*.

D. Geological and Geophysical Expenses

Most arguments suggest that the current two-year amortization schedule deduction allowed for nonintegrated companies be increased to seven years, like integrated companies.[235] However, generous deductions for geological research may be the key to balancing the costs associated with repealing other oil and gas tax subsidies.[236] One of the justifications for repealing many subsidies is that drilling for oil and gas is no longer the same experience as it was before the 1950s.[237] Those days of drilling into "black holes" are gone.[238] Current technology, including seismic 3-D imaging and other technological advances, reduces much of the risk associated with exploration and drilling.[239] Technology is the key to lowering risks and costs in producing oil.[240]

Additionally, new technological advances in extraction have increased the volume of oil and gas available to the public.[241] One example of this is the oil sands of Canada.[242] Oil sands were previously too costly to be mass-produced, but as oil prices continued to rise, it become economical to fund multibillion-dollar research into their extraction.[243] Because of this research, Canada could become a new energy superpower, and America could become its number one

[235] *See, e.g.*, Cecil, *supra* note 24, at 217-218 (suggesting that nonintegrated companies geo-research deductions should match integrated company standards).
[236] *See supra* Part II & V (listing all tax subsidies that should be repealed).
[237] *See supra* Part IV.A (noting that the risk associated with drilling is substantially reduced due to technological drilling and imaging advances).
[238] *See* Starkman, *supra* note 23, at 189 (recounting the historical attitude risks to current risks taken by oil and gas drillers).
[239] *Id*.
[240] *See generally*, Krauss, *supra* note 150 (arguing that new oil and gas technology is currently in it's infancy and is predicted to change the course of the fossil fuel future).
[241] *See e.g.*, Krauss, *supra* note 154 (explaining the story behind the technological advances associated with oil sands and other extraction techniques).
[242] *Id*.
[243] *Id*. Over $120 billion dollars has been invested in this "mega-resource". DANIEL YERGIN, THE QUEST: ENERGY, SECURITY, AND THE REMAKING OF THE MODERN WORLD 256 (1st ed. 2011)

partner.[244] Technological advances have affected prices, supply, and even stability by providing America a potential pseudo-domestic trading partner in Canada.[245] Although trading with Canada does not necessarily entail "energy independence," the political environment surrounding agreements and deals with them are much friendlier than with the Middle East.[246]

The Orinoco belt in the interior of Venezuela presents a similar story.[247] The production of this unconventional oil was difficult to and costly – too costly for the State of Venezuela to pursue alone.[248] So in the 1990s, they invited other international companies to collaborate in a joint venture, investing upwards of $20 billion.[249] After some pushing, especially in the technology arena, production is up to 600,000 barrels a day, with more likely to come.[250]

Technological advances in geological research also affect the environmental impact of exploration and extraction.[251] Several factors, such as the growth in supply and ability to extract the resources, show that the fossil fuel age could persist for much longer than originally anticipated.[252] The industry is continuing to find new sources, including oil sands, deep water reserves, shale rock, and artic reserves.[253] The industry is also finding new and advanced ways to

[244] *Id.*
[245] *Id.*
[246] *Id.*
[247] *See* YERGIN, *supra* note 247, at 257–59 (narrating the story of the production of Orinoco oil).
[248] YERGIN, *supra* note 247, at 258.
[249] *Id.*
[250] *Id.* at 259.
[251] *See* DANIEL YERGIN, THE QUEST: ENERGY, SECURITY, AND THE REMAKING OF THE MODERN WORLD 257 (1st ed. 2011) ("technology for producing oil sands continue to evolve, and increasing ingenuity is being applied to shrinking the environmental footprint and reducing the CO_2 emissions in the production process").
[252] Krauss, *supra* note 150.
[253] *Id.*

extract these resources in methods unimaginable even as recent as a decade ago.[254] And with this growth in supply, environmentalists are demanding that extraction, transportation, and exploration are performed in ways that leave smaller footprints.[255]

Generally, increasing production of oil and gas equates to increasing pollution.[256] For example, oil sand extraction causes many environmental concerns due to the destruction of boreal forests and the release of carbon due to refining methods.[257] But just because the fossil fuel age may continue indefinitely doesn't mean the environment must continue deteriorating, especially at this rate.[258] The solution to reducing environmental impact may be efficiency, also nicknamed the "fifth fuel."[259] As shown, technological improvements have streamlined the refinement process causing less carbon emissions, and the use of steam injections has left a smaller footprint of damage to forests.[260] These advances have also partnered with the technological advancement of more efficient cars, airplanes, and homes, synergizing the effects of these technological advances.[261] However, without economic incentives such as tax breaks, oil companies are less likely to direct generous funds towards research, especially in regards to

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[254] *Id. See e.g.*, DANIEL YERGIN, THE QUEST: ENERGY, SECURITY, AND THE REMAKING OF THE MODERN WORLD 255 (1st ed. 2011) ("[i]t was not until the late-1990s that the oil sands finally began to prove themselves as a large-scale commercial resource").

[255] *See, e.g.*, John M. Broder & Dan Frosh, *Politics Stamps Out Oil Sands Pipeline, Yet it Seems Likely to Endure*, N.Y. TIMES (Dec. 23, 2011), http://www.nytimes.com/2011/12/24/us/provision-may-halt-keystone-pipeline-but-oil-is-still-likely-to-flow.html (mentioning environmentalists' protests outside the White House against the Keystone Pipeline).

[256] *See* Krauss, *supra* note 150 (describing the research advances related to lowering the carbon footprint of oil sand extraction).

[257] *Id.*

[258] *Id.*

[259] YERGIN, *supra* note 247 at 614–15.

[260] Krauss, *supra* note 150.

[261] *See* YERGIN, *supra* note 247 at 615, 621–22 (illustrating, as examples, that a combination of more efficient cars, housing, industry, and airplanes has resulted in America's "lighter" economy).

Back to Table of Contents

environmental concerns.[262] This illustrates that tax subsidies should be reserved for purposes that cannot be driven by the market alone.[263]

Another reason why the amortization schedule for oil and gas research should be left alone, or even increased, is that research should be an encouraged industry in America.[264] Generally, the taxpayer can make an election to deduct or capitalize research and experimental expenditures.[265] This is allowed even though research costs can potentially lead to future profits, and any costs that lead to future profits are mainly capitalized.[266] One can infer that research, as a good social policy, is one of the reasons for allowing this taxation anomaly.[267] This reason is also supported by the groundbreaking technological advances demonstrated by geologist and geophysicists, who have drastically lowered the cost and risk of obtaining oil while simultaneously increasing the supply.[268]

Lastly, one of the greatest fears of repealing oil and gas tax subsidies is the increase in prices that consumers may experience.[269] Especially upon recalling the national outcry when gas

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262 *See* YERGIN, *supra* note 247 at 255 (reflecting on the theory that Canada's high-tax national energy policy resulted in the abandonment of oil sand exploration in the 1970s and that a tax reform in the 1990s revived interest, resulting in major technological advancements).

263 *Id* at 625 (conveying that there is less incentive to invest in environmental ventures that do not result in some sort of ceremony, or "cut[ting] a red ribbon").

264 *See* Livingston, *supra* note 1, at 218 (recalling the social benefits of research, such as national pride and identification of Americans towards technological advancement and the belief that it is the "modern equivalent of the frontier.")

265 GRAETZ, *supra* note 3, at 335–36.

266 *See id.* at 336 (inferring that an anomaly exists when Congress allows a deduction for a cost that should be otherwise capitalized).

267 *Id.*

268 *See generally,*

269 *See generally* Dillon, *supra* note 33, at 54 (discussing consumer fear of suffering the consequences of high oil and gas prices and who should actually bear those costs, suppliers or consumers).

prices rose above four dollars a gallon.[270] Although complicated arguments about whom should bear the rising costs of oil and gas ensues (the government, the supplier, or the consumer?),[271] research and technology advances can offset rising costs.[272] For example, suppose domestic shale rock and Canadian oil sands become a more viable source of oil and gas.[273] Prices for oil and gas could decrease or remain stable, just through the political stability of those oil and gas sources.[274] This can be credited to the formerly unimaginable technological advances in geological research.[275]

That being the case, Congress should think twice before blindly repealing any and all advantageous oil and gas tax subsidies. Subsidies for geological research and technology can be differentiated from other oil and gas tax subsidies in the way it affects certain aspects of oil and gas that the other tax subsidies do not.[276] Some of the ways that research affects other facets of

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[270] Diane Cardwell, *Oil Prices Predicted to Stay Above $100 a Barrel Through Next Year*, N.Y. TIMES, (Dec. 28, 2011) http://www.nytimes.com/2011/12/29/business/oil-prices-predicted-to-remain-above-100-a-barrel-next-year.html (stating that four dollar a gallon as a "price shock" and forced Americans to change the way they consume gas, resulting in cutbacks in driving).
[271] *See generally* Dillion, *supra* note 33, at 54 (suggesting that suppliers should bear the grunt of the cost, not consumers).
[272] *See generally* Krauss, *supra* note 150 (explaining that technological advances are lengthened the fossil-fuel age because increasing supply and lowered prices have shifted the focus away from alternative energy back to fossil fuels).
[273] *See id*. (introducing unconventional forms of oil and gas, such as shale rock and oil sands).
[274] *See* YERGIN, *supra* note 247, at 268 (suggesting that what we are really looking for is not energy independence, but energy "security"). *See* Krauss, *supra* note 150 (suggesting that a partnership with Canada over the oil sands would be politically stable).
[275] *See generally* Krauss, *supra* note 150 (recalling examples of technological advances that have given rise to greater access to oil and gas in areas previously off-limit); YERGIN, *supra* note 247, at 253–259 (narrating the technological and economic struggles faced by those in Canada and Venezuela to develop their domestic oil sources).
[276] *See supra* Part II.A–I (listing all subsidies that could be repealed). *But see supra* Part II.D, Part IV.D (describing the tax subsidy for geological and geophysical costs and why they should not be repealed).

oil and gas include lowering the environment footprint and prices, while increasing efficiency and supply, and generally promoting the social good of research, science, and knowledge.[277]

On the other hand, one could explore a middle ground solution between increasing the geological and geophysical amortization period[278] and allowing immediate cost deduction by allowing deductions for research and exploration with a "green" effect. For example, costs related to exploration, drilling, or refining that involve low-carbon emissions or other methods that are environmentally friendlier, should be deducted immediately.

E. Passive Loss Exceptions For Working Interests

Passive loss exceptions for working interests should be repealed because most investors in this category do not actually have what is commonly known as "working interests."[279] Most of these types of investors are not actually burdened by the cost of development and operation of the oil and gas projects.[280] For example, the requirements of a person who "materially participates" in an activity are notably more stringent than the what is expected of a working interest owner of an oil and gas well.[281] In order to materially participate, one must either spend more then 500 taxable hours per year on the activity, perform substantially all of the activities of a typical "material participant," equal or exceed the participation of others, participate for any

[277] *See generally* Krauss, *supra* note 150 (explaining how technological advances have increased supply, thereby lowering prices for oil and gas).
[278] *See* Pirog R41139, *supra* note 142, at 5 (discussing arguments for increasing the amortization period for geological and geophysical research).
[279] *See* Cecil, *supra* note 24, at 217-18 (listing examples of these types of investors are ones involved in production payments, overriding royalties, and certain contract rights).
[280] *Id.*
[281] GRAETZ, *supra* note 3, at 415. *See supra* Part II.E (listing the ownership qualifications of a generic taxpayer who "materially participates" in an income-producing activity).

five of the last ten prior years, materially participate in a "service activity," or prove by facts and circumstances that he or she is a material participant.[282]

The reasons for repealing this subsidy are numerous and compelling. First, investments should be formed based on market information, not tax incentives.[283] Second, this repeal could be a disincentive for investing solely to use oil and gases losses to offset other income.[284] And third, market supply and demand provides enough incentive to investors without the aid of this subsidy.[285]

F. Deductions for Tertiary Injections

Provisions that are out-of-date and underutilized (or not utilized at all in this case) should be repealed in order to maintain modern, not archaic, laws and codes.[286] However, this may entail the use legislative resources that could be directed elsewhere.[287] Hence, deductions for tertiary injections provides an example of why some tax subsidies should include sunset provision, otherwise known as sunset laws.[288] Sunset provisions will force lawmakers to

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282 *Id.*
283 Cecil, *supra* note 24, at 217.
284 *Id.*
285 *Id.*
286 *See* Starkman, *supra* note 21, at 191 ("[w]e now have an opportunity to revisit all the 100-year-old tax bounties conferred on a small group of preferred taxpayer"); *Id.* at 192 ("[t]his anachronistic tax policy is overdue for a thorough review").
287 *See* LOWE, *supra* note 54, at 332 (speculating that one of the reasons why beneficial oil and gas taxes remain is because no sunset provisions were attached).
288 *See* LOWE, *supra* note 54, at 332 *(speculating that one of the reasons why beneficial oil and gas taxes remain is because no sunset provisions were attached).* Sunset laws are statutes under which a governmental agency or program automatically terminates at the end of a fixed period unless it is formally renewed. BLACK'S, *supra* note 59 at 680.

constantly reevaluate the purpose and justification associated with every credit or deduction provided.[289]

Others may argue that carbon dioxide injections are beneficial for the environment or may cause oil and gas prices might to drastically fall.[290] However, these exceptions are under-inclusive and, once again, highly unlikely.[291]

G. LIFO Inventory Accounting

The LIFO Inventory Accounting principle for oil and gas companies should be repealed to make taxes fairer.[292] The most common methods of accounting are the accrual method and the cash method, respectively.[293] The purpose of accounting methods is to accurately reflect the financial state of a company.[294] Oil and gas companies should not use an accounting method that distorts and potentially exacerbates their profits, especially in times of rising oil and gas prices.[295] Additionally, LIFO should be repealed to promote consistent accounting amongst all oil and gas companies, especially because LIFO is not an internationally accepted standard,[296] and oil and gas is part of a worldwide market.[297]

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[289] *See* Ohio Legislative Service Commission, *Legislative Oversight*, 2012, at 75, *available at* http://www.lsc.state.oh.us/guidebook/chapter7.pdf ("The purpose of a sunset provision is to force a systematic evaluation of an agency or program by establishing a specific date for the termination of the law creating the agency or program)"
[290] Cecil, *supra* note 24, at 219.
[291] *Id*.
[292] Johnson, *supra* note 77, at 582–83.
[293] GRAETZ, *supra* note 3, at 672.
[294] *Id*.
[295] *See supra* Part II.G (noting that the LIFO accounting method is more advantageous during times of rising prices).
[296] GRAETZ, *supra* note 3, at 672.
[297] *See*, Krauss, *supra* note 150 ("demand for energy is going to increase by 50 percent by 2035, largely because of increased consumption in China, India and the rest of the world").

Back to Table of Contents

H. Pool of Capital Doctrine and Carried Interests

The Pool of Capital Doctrine and Carried Interests should be repealed because it goes against the general tax rule without a compelling reason.[298] Although no cash has been exchanged, it has long been established that barter exchanges, or non-cash exchanges, are a taxable event.[299] And in this case, there is an exchange for an underlying asset, the interests in the oil or gas, which should be taxable.[300] More specifically, the fair market value of both sides of the transaction should be taxed.[301] That means including in income, the recipient who is receiving compensation for goods, services, and the use of their property, and the transferor who is exchanging the interest in the oil or gas for those goods, services, and property use.[302] The repeal of this subsidy would result in a fairer tax.[303]

In some cases, non-cash exchanges, such as Like-Kind Exchanges, can be exchanged without a taxable realization event, until that Like-Kind Property is eventually sold.[304] This is done primarily to protect taxpayers who have no cash and to avoid the difficulty of valuing these trades.[305] Now compare the oil and gas industry's situation to that of the poor farmer, exchanging land and trucks.[306] The difference between the two is that oil and gas companies do

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[298] Johnson, *supra* note 77, at 574.
[299] I.R.C. § 6045(c)(1)(B) (2006); GRAETZ, *supra* note 3, at 103, 130.
[300] Johnson, *supra* note 77, at 574; *see also supra* Part II.H (addressing tax policy which usually require the tax recognition of cashless exchanges).
[301] Bodgdanski, *supra* note 20, at 328.
[302] *Id*.
[303] *Id*; *see also* Johnson, *supra* note 77, at 574.
[304] GRAETZ, *supra* note 3, at 636.
[305] *Id*. at 641.
[306] *See generally id*. (referring to examples of land and trucks in like-kind exchanges).

Back to Table of Contents

not lack either cash or the ability to value their product.[307] Therefore, the policy reasoning behind this subsidy does not stand, especially due to the growing prosperity of oil and gas companies.[308]

I. Credit for Enhanced Oil Recovery Costs and Marginal Well Tax Credit

The easiest tax deductions to cut are the ones that are currently not utilized, have not been utilized for some time, and will most likely not be utilized in the next decade.[309] That means that the credit for enhanced oil recovery costs[310] and marginal tax credit[311] can be confidently repealed.[312] Both of these credits are utilized only during periods of low prices, which will most likely not be reached as long as the U.S. continues to consume oil and gas at its current rate.[313]

V. CONCLUSION

Most of the tax subsidies for oil and gas companies should be repealed in order to create a fairer tax system,[314] sway investors towards alternative energy,[315] and raise revenue for the

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[307] *See* Energy and Oil Prices, BLOOMBERG (last visited Feb. 25, 2012, 10:47PM), http://www.bloomberg.com/energy/ (listing current oil and gas prices).
[308] Bodgdanski, *supra* note 20, at 328; *see also* Johnson, *supra* note 77, at 574. *See supra* note 29 and accompanying text (listing ExxonMobil, Chevron, and ConocoPhillips as three of the top twenty-five largest public companies in the world.)
[309] *See* OIL AND GAS TAX PROVISIONS, *supra* note 124 (statement of Alan B. Krueger, Assistant Secretary for Economic Policy and Chief Economist, United States Department of the Treasury); Cecil, *supra* note 24, at 215-16.
[310] *See supra* Part II.I (describing the credit for enhanced oil recovery cost is currently under utilized).
[311] *See supra* Part II.J (describing the credit for marginal tax is currently under utilized).
[312] Cecil, *supra* note 24, at 215-16.
[313] *See supra* Parts II.I-J (addressing that both of these subsidies are underutilized because prices are too high).
[314] *See supra* Part III (arguing that one of the reasons for repealing oil and gas subsidies is to create a more even playing field amongst industries, such as the alternative energy industry compared to the oil industry).
[315] *See id.* (arguing that oil and gas subsidies must be relinquished because the disparity in investing in oil and gas compared to alternative energy is already so great).

federal government.[316] However, subsidies towards geological and geophysical research should not be repealed.[317] This is because research has benefited exploration and extraction by increasing supply and efficiency, and decreasing pollution.[318] And, research has also diminished one of the reasons for which many of these subsidies were created in the first place, the industry's high-risk nature.[319]

And yet, while repealing these tax subsidies taxes may immediately increase revenue and create a fairer tax system,[320] many other factors must fall into place if society is to increase its usage of alternative energy.[321] To do so, society must reduce oil and gas consumption, mainly by embracing alternative-energy cars.[322] But at the current moment, progress towards alternative energy solutions may be prolonged because the supply of oil and gas is rising,[323] as is demand.[324]

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[316] *See id*. (reiterating that experts predict an increase in $36 billion in the next decade, if oil and gas subsidies are repealed).

[317] *See supra* Part IV.D (arguing that geophysical and geological research may offset the possibility of price increase and foreign oil dependence which may result from the repeal of other oil and gas subsidies).

[318] *See supra* Part IV.D (recalling the advances that research has made towards the extraction of oil from Canadian oil sands, and gas from American shale rock, among others).

[319] *See* Parts IV.A-B (noting that percentage depletion and intangible drilling costs, two of the most commonly used oil and gas subsidies, were primarily implemented to reduced the risk of drilling to "place holes").

[320] *See supra* Part III (noting that both of these results are highly likely, as forecast by many analysts and industry experts).

[321] *See id*. (noting that a decrease in investment in oil and gas does not equate an increase in investment into alternative energy).

[322] *See* YERGIN, *supra* note 247, at 709–710 (explaining the possibilities of "the car[s] of the future"). Cars release 17 percent of the carbon emissions in the atmosphere. *Id*. at 693.

[323] *See* YERGIN, *supra* note 247, at 227-28, 237 (1st ed. 2011) (explaining that throughout history, experts have predicted the end of the oil supply, but as technology continues to expand on the availably of oil, the plateau on oil will only begin in the 2050s).

[324] *See* Krauss, *supra* note 150 (projecting oil and gas supply to increase as access increases due to technological advancements in extraction and refinement).

Nevertheless, these first steps are crucial towards the development of an energy-efficient future.[325]

[325] *See* YERGIN, *supra* note 247, at 614 ("One energy resource has the potential to have the biggest impact of all . . . It goes by different names–*conservation, energy efficiency, energy productivity*").

Back to Table of Contents

The Regressive Monster

Resolving Issues With The Value Added Tax

Spring 2012

Back to Table of Contents

The Regressive Monster
Resolving Issues With The Value Added Tax

Table of Contents

Introduction 1

Assumptions for a Baseline VAT Model 2

Methods of Calculating the VAT 4

Comparison of the VAT to a Sales Tax 8

The Equity of the VAT 13

Methods to Alleviate the Regressive Nature of the VAT 15

  Exempting Goods and Services 15

  Zero-Rating Goods and Services 19

  Zero-Rating Entities 21

  Multiple Rate VAT Structure 25

  The VAT Credit or Demogrant 27

Exempting Entities 31

Stand Alone VAT 33

The VAT with the Progressive Income Tax Structure 37

Conclusion 40

Back to Table of Contents

The Regressive Monster
Resolving Issues With The Value Added Tax

Introduction

The current budget deficit and national debt levels are anything but highly guarded secrets.[1] However, the diminishing fiscal solvency of the United States has come to the forefront in recent months.[2] With the presidential election looming, candidates have presented a myriad of approaches to U.S. tax policy in hopes of alleviating our fiscal situation (or at the very least securing their party's nomination).[3] Among the items in debate, the value added tax (VAT) appears to be the most intriguing. Though only a topic of debate in the U.S., the VAT has already been implemented in several other nations.[4] In fact, the United States is the only large developed economy which does not implement some form of VAT.[5]

Although various forms of the VAT system have been implemented in other countries, a consistent criticism of these systems is their regressive nature.[6] Governing bodies have taken differing approaches to alleviate the purported regressive effects of the VAT; but is it truly regressive? If so, are the methods implemented by these nations effective in reducing the

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[1] *See* Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Year 2012 to 2022* (2012), http://www.cbo.gov/sites/default/files/cbofiles/attachments/01-31-2012_Outlook.pdf (stating that $10.01 trillion in federal debt was held by the public at the end of 2011 and projecting a $1.1 trillion federal budget deficit for fiscal year 2012 if current laws remain unchanged).

[2] Zachary Roth, *Obama, Romney Release Dueling Tax Plans*, Yahoo! News, Feb. 22, 2012, http://news.yahoo.com/blogs/ticket/obama-romney-release-dueling-tax-plans-201440529.html.

[3] The Urban-Brookings Tax Policy Ctr., *Summary of Major Tax Proposals by GOP Presidential Candidates* (Feb. 23, 2011), http://taxpolicycenter.org/taxtopics/upload/Feb-23-2012-GOP-Summary-2.pdf.

[4] *See* William G. Gale & Benjamin H. Harris, *A Value-Added Tax for the United States: Part of the Solution*, *in* The VAT Reader: What a Federal Consumption Tax Would Mean for America 64 (Meredith Stevenson Fath ed., 2011), available at http://www.taxanalysts.com/www/freefiles.nsf/Files/VATReader.pdf/$file/VATReader.pdf (stating that the VAT is in place in about 150 countries worldwide).

[5] *Id*. (stating that the VAT has been implemented in every OECD country other than the United States).

[6] Richard Murphy, *Is VAT Regressive and If So Why Do the IFS Deny It?* (July 2010), http://www.taxresearch.org.uk/Documents/VATRegressive.pdf (expounding on the regressive effects of the VAT as instituted in the United Kingdom).

regressive impact of the VAT? How can the experiences of these foreign nations be applied to effectively implement the VAT in the United States? According to calculations, the imposition of a 5% VAT in the U.S. would enable the government to reduce the national debt by nearly a third within ten short years, assuming that all other revenue and spending levels remain constant.[7] Given the potential rewards, it is essential that these plaguing issues be addressed.

Assumptions for a Baseline VAT Model

Before analyzing the impacts of a VAT, a baseline model from which to begin the analysis is necessary. This paper begins by laying out a typical VAT transaction and the most prominent methods of calculating the VAT. It then analogizes the VAT to the familiar sales tax system, forms of which have already been established in the majority of American states. It proceeds to discuss the equity implications of the VAT and solutions to its potentially regressive effects. Some proponents of the VAT call for replacing the current income tax regime or at least parts of it, rather than implementation of the VAT in addition to the existing system.[8] This discussion analyzes the effects of repealing the federal income tax in favor of the VAT and moves on to cover the impacts of a dual taxation system where a VAT is layered on top of the existing income tax system.

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[7] The Urban-Brookings Tax Policy Ctr., *Microsimulation Model* (Nov. 12, 2009), http://www.taxpolicycenter.org/numbers/Content/PDF/T09-0442.pdf (showing that a 5% tax exclusive VAT imposed in addition to the current income tax regime would raise approximately 3 trillion from 2010 through 2019).

[8] Pat Choate, *VAT and the Great Tax Swap*, THE HUFFINGTON POST, Apr. 26, 2009, http://www.huffingtonpost.com/pat-choate/vat-and-the-great-tax-swa_b_551120.html (proposing eliminating the existing U.S. personal and corporate income tax system altogether and replacing it with a VAT).

Back to Table of Contents

Resolving Issues With The Value Added Tax

The basic underpinning of a VAT is a broad-based tax on consumption which requires taxpayers to collect and remit taxes at each level of the production and distribution process.[9] The tax is effectively imposed on the "value added" at each stage of the process.[10] For example, consider the production cycle of wooden tables with a 10% VAT in place. Adam owns and operates a timber farm. He processes and sells treated lumber to Bill for $1,000.[11] At this point, the government imposes a $100 tax on the value added by Adam.[12] Adam would price this tax into the amount that he charges Bill for his lumber and separately state the tax on the sales receipt. Bill uses the lumber to produce $2,000 worth of tables which he then sells to a retail store. Bill is then required to remit taxes on the $2,000 sales price. However, Bill will receive a tax credit for the amount of VAT already paid to Adam in his lumber purchase transaction. In order to ensure that Bill takes the proper amount of credit, he can refer to the receipt issued by Adam. As such, Bill will be required to remit $100 in VAT.[13] When the retail store sells the tables to consumers for $2,500, it is required to remit taxes on the proceeds of its distribution activities. Again, the retail store receives a credit for the tax previously remitted in the value chain. As a result of this transaction, the retail store is required to remit $50 of VAT.[14] In consummating the various transactions in the production cycle of the tables, the final sales proceeds were $2,500, of which the government is entitled to 10% or $250. The tax is ultimately

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[9] Taxation and Customs Union, European Commission, *General Overview of the VAT* (Mar. 31, 2012), http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/index_en.htm.

[10] *Id*.

[11] Assume, for the sake of simplicity, that Adam does not incur any VAT in his timber operations.

[12] $1,000 sales proceeds x 10% tax rate = $100 VAT to be remitted.

[13] $2,000 sales proceeds x 10% tax rate = $200 VAT on sales proceeds - $100 tax already remitted by Adam = $100 VAT to be remitted.

[14] $2,500 sales proceeds x 10% tax rate = $250 VAT on sales proceeds - $200 of tax already remitted by Bill and Adam = $50 VAT to be remitted.

Back to Table of Contents

borne by the retail consumer because he does not have anyone further down the value chain on whom to pass on the costs.[15]

Methods of Calculating the VAT

The example given presents the VAT as it functions under the credit invoice method, the most widely used method of calculating the VAT.[16] However, there are other methods under which parties can reclaim the VAT paid at earlier stages in the value chain.[17] Japan, for instance, uses the subtraction method.[18] Under this method, the taxpayer arrives at its value added amount by taking its sales proceeds and subtracting the cost of its inputs.[19] The taxpayer then multiplies its value added amount by the applicable VAT rate to arrive at the amount of tax to be remitted.[20] Though not widely implemented, variants of the subtraction method VAT have been proposed as alternatives to the income tax in the United States in the past.[21] Several other methods of calculating VAT liability have been posited, but these variations have not been implemented by any of the developed nations and are beyond the scope of this article.[22]

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[15] *See* Itai Grinberg, *Where Credit is Due: Advantages of the Credit-Invoice Method for a Partial Replacement VAT*, 63 TAX L. REV. 309 (2010) (explaining the practical application of the credit invoice method VAT).

[16] *Id.* (stating that existing national level VATs almost exclusively use the credit-invoice method.).

[17] *Id*. (describing the attributes of different variations of credit invoice method and subtraction method VATs).

[18] *Id*. at 320 (stating that Japan uses a hybrid subtraction method VAT which incorporates some credit invoice method features).

[19] *Id*. at 316.

[20] *Id*.

[21] *See* Robert E. Hall & Alvin Rabushka, *The Flat Tax* (2d ed. 1995); *see also* David Bradford*, The X-Tax in the World Economy* (Nat'l Bureau of Econ. Research, Working Paper No. W10676, 2004) (proposing modified versions of the subtraction method VAT to reform U.S. taxation).

[22] Ernst & Young, *Value Tax: A Study of Methods of Taxing Financial and Insurance Services* (1998), http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/reports_published/methods_taxing.pdf (discussing the addition method, cash flow method and ad hoc methods of calculating VAT liability as they apply to the financial services and insurance industries).

The primary benefit of the credit invoice method over the subtraction method is ease of administration.[23] In auditing a taxpayer using the credit invoice method, taxing authorities can simply verify purchase receipts to determine that the amount of VAT credit taken is substantiated and the proper amount of tax has been remitted.[24] Under the subtraction method, however, the VAT audit would resemble an IRS audit. The sales and all input expenses must be substantiated in order to determine the value added amount and the underlying tax must then be recalculated.[25] The administrative costs of using the subtraction method would far exceed those under the credit invoice method.

Another benefit of the credit invoice method is functionality. International taxation is the bane of our current income tax regime. The United States system of taxing worldwide income creates significant conflicts and compliance burdens in its interaction with the territorial tax system employed by other countries.[26] In addition to the compliance burden, it is widely argued that the disadvantages of worldwide taxation reduce the competitiveness of U.S. companies in the global market.[27] The debate has recently moved to replace the complex international section of the tax code with a simpler set of territorial rules.[28] These issues can be avoided with respect to the VAT, if the United States adopts the credit invoice method in a manner consistent with

[23] *See* Grinberg, *supra* n. 15, at 323 (analyzing the key design features of the credit invoice method and the subtraction method VATs).

[24] *Id*. at 319 (describing the lack of an invoice requirement in the subtraction method VAT).

[25] *Id*.

[26] Paul W. Oosterhuis et al., *Territorial Tax Study Report* (June 11, 2002), http://www.nftc.org/default/Tax%20Policy/06_13_02_Territorial_Tax_Study_Report.pdf (exploring the basic features of a territorial tax system).

[27] *Id*.

[28] *Id*.

that being employed by the majority of its developed trading partners.[29] The congruity in VAT systems would allow U.S. companies to participate in the global market with fewer compliance hurdles to overcome.[30] The credit invoice method would also allow the U.S. to maintain its competitiveness in the global market in terms of pricing products.[31]

Under the subtraction method, U.S. importers would be able to sell products which have no VAT imbedded in their costs.[32] Most countries impose a destination basis VAT, under which exports are not subject to VAT in the exporting country and imports are subject to the VAT in the importing country.[33] Under the subtraction method, only the value added by importers in the U.S., as measured by their sales revenue less cost of goods sold and operating expenses, would be taxed.[34] This would allow overseas manufacturing and production value added to escape both foreign and U.S. taxation, giving foreign goods a cost advantage over their U.S. counterparts.[35] At the same time, goods manufactured in the U.S. for export would be laden with two levels of VAT.[36] These goods would first be taxed on the value added to them within the U.S., then taxed again when they reach their foreign destination.[37] This issue may be resolved by exempting domestic export companies from the VAT and limiting the deductions available to importers, but

[29] *See* Grinberg, *supra* n. 15, at 321.

[30] *Id*.

[31] *Id*.

[32] *Id.* at 352 (stating that a lack of continuity between EU and Japanese rules leads to significant double taxation and double non-taxation).

[33] *Id.*

[34] *Id*.

[35] *Id*.

[36] *Id*.

[37] *Id*.

the complexity of this policy would impose additional compliance and administrative costs.[38] Under the credit invoice method, importers would receive no VAT credit for goods purchased overseas for U.S. import. As such, the entire value of imports would be subject to VAT in the U.S. if they escape VAT in the exporting country.

In situations where a taxing authority wishes to impose multiple VAT rates, the credit invoice method is almost required to be used.[39] Under the credit invoice system, auditors can easily verify the amount of VAT paid by the taxpayers' suppliers.[40] Even if different rates are applied to different products, the actual amount of VAT paid on each input is clearly stated on the purchase receipt.[41] In a subtraction method system, the process is much more difficult.[42] Suppose a retailer sells products that are subject to multiple tax rates. In verifying the amount of VAT due, the auditors must categorize the sales transactions and respective inputs by tax rate.[43] Unfortunately, this information may not be as readily available as it is under the credit invoice method.[44] Without a paper trail, it would be nearly impossible to verify transactions. This would effectively force the taxing authority to pass regulations requiring taxpayers to maintain records in formats conducive to allowing effective administration. In making modifications to the

[38] *Id*. at 322.

[39] *Id*. at 329.

[40] *Id*. at 330.

[41] *Id*.

[42] *Id*.

[43] *Id*.

[44] *Id*.

subtraction method, the burden on both taxpayers and the taxing authority is increased.[45] These considerations clearly identify the credit invoice method as superior to the subtraction method.[46]

Comparison of the VAT to a Sales Tax

Commentators often analogize the VAT to another consumption tax with which most Americans are quite familiar, the retail sales tax.[47] However, there are some key differences which make the VAT a more effective tax structure than the sales tax. Unlike a traditional sales tax, which imposes a flat rate of tax on the end consumer, VAT collections occur at each stage of the production and distribution process.[48] This variation offers inherent benefits and burdens.

The most conspicuous benefit of the VAT is that it generates greater revenue collections than a retail sales tax.[49] Under a sales tax regime, some unscrupulous vendors could make sales under the table, thereby circumventing their obligation to collect and remit sales tax.[50] Under a VAT system, however, even if a retailer fails to perform his duties, the majority of the taxes would have already been remitted along the production process.[51] It would also be more difficult for intermediary vendors to game the system because the tax due on their sales would be accounted for when the next vendor calculates his share of taxes to be remitted.[52] Under a credit invoice system, a taxpayer would not be able to claim a credit for taxes paid at the previous level without substantiation in the form of a receipt or invoice from the previous vendor showing the

[45] *Id*.
[46] *Id*.
[47] *Id*.
[48] *Id*.
[49] *Id*.
[50] *Id*.
[51] *Id*.
[52] *Id*.

Back to Table of Contents

amount of taxes actually paid. The failure to remit VAT by a vendor would be of immediate concern to a purchaser because the purchaser would be liable for the unpaid taxes. As such, it can be argued that the VAT would result in increased compliance rates and greater revenue collections when compared to an identical rate retail sales tax imposed on an identical tax base.[53]

The benefit of increased collections, however, may be offset by the burden of increased efforts in compliance and administration. The burden of collecting and remitting the VAT is placed on all taxpayers involved in the value chain, rather than just the retailers.[54] As such, the VAT involves multiple fold more transactions to regulate than a traditional sales tax. Whereas the sales tax system requires only the final sales transaction to be reported to and verified by taxing authorities, the VAT system requires the regulation of multiple transactions in the sale of a single product. The additional administrative burden of regulating the relatively large number of transactions may be significant when compared to a traditional sales tax. Offsetting the burden of regulating a copious number of transactions, the taxing authority may have the option of auditing fewer transactions. The higher level of compliance expected in a VAT system over a sales tax system would reduce the risk of understatements and, in turn, the level of regulation required. In any event, the burden of the administration would be significantly less than what the IRS faces in administering our current system if the VAT system replaces the income tax.[55]

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[53] *Id*.

[54] *See* Sijbren Cnossen, *Administrative and Compliance Costs of the VAT: A Review of the Evidence*, TaxNotes, vol. 62, no. 12, June 20, 1994, at 1609 (examining the administrative costs of a VAT).

[55] *See* Gale et al., *supra* n. 4, at 72 (stating that the administrative costs of the VAT in the UK were less than half of those of the income tax when measured as a percentage of revenue).

Imposing a VAT in addition to the current income tax structure would require additional resources, but the revenues generated would likely outweigh the additional costs.[56]

Although both the VAT and sales tax are effectively imposed on the end consumer, the VAT is a "hidden tax" in the sense that consumers do not necessarily see the direct burden that it places on them.[57] Whereas a consumer pays sales tax in addition to the listed price of the product, the VAT is built into the final sales price of the product.[58] Unlike sales to entities in the value chain, receipts for sales to retail consumers under most VAT regimes do not show the amount of VAT imbedded in the sales price. The obligation to identify the VAT paid in sales to value adding entities is imposed to help determine the amount of credit they are entitled to. Retail consumers are not entitled to a VAT credit and need not be informed of the amount of VAT being paid. It can be argued that this makes increases in the VAT rate imperceptible to consumers, allowing the taxing authority to increase rates with little resistance.[59] Consumers may not pay attention to national debates and assume that such an increase in prices is attributable to inflation, rather than governmental actions, thus reducing the accountability of our elected officials. Although the hazard exists that taxing authorities could use the VAT as a personal printing press to fund superfluous government programs, history has shown that the tactic may not necessarily be implemented.[60] Many taxing authorities have chosen to reduce or maintain

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[56] *See* Robert Carroll & Alan D. Viard, *Value Added Tax: Basic Concepts and Unresolved Issues*, Tax Notes 1117, at 1121 (Mar. 1, 2010), http://www.aei.org/files/2010/03/01/ViardTaxNotes310.pdf (estimating that the administrative costs of a fully phased in VAT system would be approximately $1.8 billion).

[57] *See* Gale et al., *supra* n. 4, at 75.

[58] *Id*.

[59] *Id*.

[60] Bruce Bartlett, *The Case Against the VAT* (Apr. 23, 2010), http://www.capitalgainsandgames.com/blog/bruce-bartlett/1679/case-against-vat (stating that, of the 29 members of the Organization for Economic Cooperation and Development with a VAT, four have never increased their VAT rates and seven others have reduced theirs over time).

their VAT rates, but an additional safeguard would be to require retailers to list the VAT paid on retail sales receipts.[61] By doing so, consumers would be better able to identify the rate of tax paid on their purchases and question legislators if unjustified increases occur.

There has been some concern that a federal VAT would hinder the states' abilities to administer their own sales taxes.[62] In actuality, there may be significant benefits to replacing state sales taxes with a state VAT that piggybacks the federal VAT.[63] In order to reduce administrative costs and the compliance burden, many states link their income tax structure to that of the federal government.[64] States would likely obtain the same benefits by discarding their respective sales tax regimes and adopting VAT regimes linked to the federal VAT.[65] In addition to being more efficient, a piggyback VAT regime could reach transactions that escape taxation under their current sales and use tax regime.[66] States can tax only transactions over which they have jurisdiction. Specifically they can tax only items purchased or used within the borders of the state. Purchases within the state are easily regulated by imposing a duty of collection and remittance on vendors operating within the state. However, states do not have the jurisdiction to impose this duty on vendors who do not have a presence within their boundaries. As such, the issue of consumers crossing state borders in order to purchase goods at lower rates of sales tax

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[61] *See* Gale et al., *supra* n. 4, at 75 (stating that Canada administers a VAT system which requires retailers to list the VAT on receipts for consumer transactions).

[62] *See* Charles E. McLure, Jr., *How to Coordinate State and Local Sales Taxes with a Federal Value Added Tax,* 63 TAX L. REV. 639 (2010).

[63] *See* Gale et al., *supra* n. 4, at 73.

[64] *Id*.

[65] *Id*.

[66] *Id*.

has been a historic problem.[67] Although states impose an obligation to remit use taxes on its residents, it is nearly impossible to identify items purchased outside state borders and brought within for consumption. The rise of e-commerce has exacerbated the problem and caused an upheaval in the states' power to tax interstate transactions.[68] Especially with regard to small, but expensive, items, consumers may find that nominal shipping charges may be significantly less than the potential sales tax savings.

These issues can be resolved by introducing the federal government, which has jurisdiction to tax all transactions within the United States regardless of which state the product is sold from or shipped.[69] The federal government already has the power to regulate interstate commerce by virtue of the commerce clause.[70] By ceding the authority to tax interstate transactions to the federal government, the states could collect more revenues than they currently receive under incongruous sales tax regimes.[71] Taxes generated from interstate transactions can be allocated to states by implementing a uniform rule. For example, all tax revenues can be allocated to the state from which the product is shipped. Given the enumerated reasons, affixing a uniform state VAT to the federal VAT would increase efficiency and also allow the states to collect on "homeless income" from transactions which would otherwise escape taxation.[72]

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[67] J. Scott Moody, *The Great Tax Divide: Maine's Retail Desert vs. New Hampshire's Retail Oasis* (Apr. 30, 2011), http://www.mainepolicy.org/wp-content/uploads/VER-2-Path-to-Prosperity-The-Great-Tax-Divide-041311.pdf (discussing the issue of "tax shopping" engaged in by Maine citizens who travel to New Hampshire to purchase goods).

[68] *Id*.

[69] U.S. CONST. art. I, §8, cl. 3. (giving Congress the power to regulate commerce with foreign Nations, and among the several States, and with the Indian Tribes).

[70] *Id*.

[71] *See* Gale et al., *supra* n. 4, at 73.

[72] *Id.*

The Equity of the VAT

With respect to the Haig-Simons definition of income, the VAT seeks to impose a tax on the taxpayers' consumption and ignores the accretion of wealth variable. Given that the VAT is typically imposed at a constant rate throughout the tax base, proponents argue that the tax is proportional rather than regressive. Those who consume larger quantities of items included in the tax base will pay ratably higher amounts of VAT than those who consume fewer quantities. In effect, this allows taxpayers to control the amount of tax they pay by controlling the quantities of taxable goods they consume.

The primary attack on the VAT is that its impact on lower income households is greater than that on higher income households. Lower income households must consume a higher percentage of their income just to meet a basic standard of living, allowing only higher income households the luxury of saving and deferring their consumption. As such, lower income households are effectively forced to increase their tax rate through unavoidable consumption. Although the VAT may be a proportional tax in theory, the regressive effects of an unmodified VAT cannot be denied.[73] The lowest quintile of Americans consume approximately 163.2% of their annual income, while the top quintile consume only 54.3% of their annual income.[74]

The equity of the VAT must be examined from two viewpoints, horizontal equity and vertical equity.[75] Horizontal equity is concerned with the relative impact of the VAT on different

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[73] James M. Bickley, *Value-Added Tax (VAT) as a Revenue Option: A Primer* (Mar. 22, 2011), http://assets.opencrs.com/rpts/R41708_20110322.pdf.

[74] The Urban-Brookings Tax Policy Ctr., *Distribution of Consumption By Income Percentile* (Nov. 10, 2009), http://www.taxpolicycenter.org/numbers/Content/PDF/T09-0403.pdf (including imputed rental value of owner-occupied housing and third party reimbursement of medical expenditures by government and private insurers in the definition of consumption).

[75] *See* Bickley, *supra* n. 73, at 4.

taxpayers with the same amount of disposable income, whereas vertical equity is concerned with the impact varying across taxpayers with different amounts of disposable income.[76]

From a horizontal perspective, the VAT would seem to be highly inequitable in the short-term because taxpayers with identical amounts of disposable income in any given year would consume widely different amounts.[77] Over the course of a lifetime, however, low and middle income taxpayers consume almost all of their disposable income and, accordingly, would pay VAT on their cumulative lifetime income.[78] As a result, low and middle income taxpayers are in relatively equal positions.[79] High income taxpayers, however, vary widely in their consumption and may be able to avoid the VAT on a portion of their lifetime earnings by foregoing some potential consumption.[80] In the long-term, the VAT appears more horizontally inequitable across the field of high income taxpayers than low and middle income taxpayers.[81]

The VAT appears to be highly regressive in the short-term from a vertical perspective as well.[82] As disposable income rises, the ability to defer consumption rises.[83] Those with the highest quantities of disposable income in a given year have the freedom to defer the most consumption.[84] As a result, the relative percentage of tax paid decreases as disposable income

[76] *Id*.
[77] *Id*.
[78] *Id*. at 5.
[79] *Id*.
[80] *Id*.
[81] *Id*.
[82] *Id*. at 4.
[83] *Id*.
[84] *Id*.

rises.[85] Even in the long-term, the VAT appears vertically inequitable.[86] Unlike low and middle income taxpayers, high income taxpayers typically do not consume their entire lifetime earnings.[87] Any income not consumed in their lifetime would be exempt from the VAT, thus reducing the percentage of tax paid in relation to the disposable income earned over one's lifetime.[88] In order for Congress to maintain the approval of their constituents, any proposal of a national VAT must be structured in a manner which reduces the inequity and regressive impact.

Methods to Alleviate the Regressive Nature of the VAT

Exempting Goods and Services

Foreign taxing authorities have used several methods to reduce the regressive effects of the VAT.[89] One popular method is to exempt certain products from the VAT.[90] Most countries exempt the consumption of goods and services that serve the public interest, such as healthcare and education services.[91] Although it appears to be sound public policy to subsidize the consumption of these goods and services by exempting them from the VAT, the rationale behind

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85 *Id*.

86 *Id*.

87 *Id*.

88 *Id*.

89 *Id*. at 5 (stating that the most common methods of modifying the value added tax are exclusions and multiple rates, tax credits, and earmarking VAT revenues for increased social spending programs).

90 Walter Hellerstein & Harley Duncan, *VAT Exemptions: Principles and Practice*, Tax Notes, August 30, 2010, at 989, available at http://www.kpmginstitutes.com/tax-governance-institute/insights/2010/pdf/vat-exemptions.pdf (discussing the benefits and disadvantages of VAT exemptions).

91 *Id*. at 995.

these exemptions does not necessarily contemplate the regressive nature of the VAT.[92] In addition to social policy reasons, some exemptions are granted for administrative reasons.[93]

Whatever the rationale, exemptions can reduce the regressive effects of the VAT.[94] Lower income households would surely benefit from having certain necessity items exempt from the VAT, but the question as to which items to exempt presents itself. According to Masayuki Tamaoka, Associate Professor of Economics at Kobe University, household expenditures can be broken down into sixteen categories.[95] Of these categories, housing, food, medical care and education are often exempted in an effort to reduce the regressivity of the VAT. Studies have shown that consumption of food and medical services decreases as a percentage of disposable income as income rises, lending credence to the belief that exempting these items reduces the regressive impact of the VAT.[96] Education expenditures, however, typically increase as income rises.[97] This may be because children of high income taxpayers recognize the correlation between education and income level or because the children of low income taxpayers are forced to enter the job force earlier in order to support their families. Notwithstanding the benefits that

[92] *Id*. (describing circumstances in which exemptions are provided to ease the administrative and compliance burdens of the VAT).

[93] *Id.*

[94] Masayuki Tamaoka, *The Regressivity of a Value Added Tax: Tax Credit Method and Subtraction Method — A Japanese Case* (1994), http://www.ifs.org.uk/fs/articles/tamaoka_may94.pdf.

[95] *Id*. at 63 (categorizing expenditures as food; beverages; housing; fuel, light and water charges; electricity; gas; furniture and household utensils; clothes and footwear; medical care; public transportation; automobiles; education; recreation; tobacco; and other expenditures).

[96] Jaime Acosta-Margain, *Tax-Benefit Incidence Of Value Added Tax On Food And Medicine To Fund Progressive Social Expenditure* (Mar. 2011), http://www.ecineq.org/milano/WP/ECINEQ2011-194.pdf (stating that people at the bottom of the income distribution spend 44.3% of their income on food and medicine, whereas those at the top spend only 15.7%).

[97] Ron Haskins et al., *Promoting Economic Mobility* (May 2009), http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Economic_Mobility/PEW_EM_Haskins%207.pdf (stating that only 34 percent of children from families in the bottom income quintile enroll in college, whereas children in the top quintile have an enrollment rate of nearly 80 percent).

may be derived from exempting education, there would likely be a public outcry if the government imposed the VAT on education. Rapidly rising education costs have plagued the United States for the past several decades, and the government has been criticized for not taking corrective measures.[98] Any government action that affirmatively increases education costs would surely come under a harsh light.[99] Assuming that only housing, food, healthcare and education are exempt and all other items are taxed at a uniform rate, the VAT appears to be quite simple. Despite the simplicity in theory, the implementation of the VAT may prove to be a challenge in practical terms.

The first issue that arises is how to delineate between taxable and exempt items. If the government chooses to exempt food, it needs to define exactly which foods will be exempt and which ones will not. Exempting any product that can be categorized as food would unduly narrow the tax base and result in significant loss of revenues. Food ordered at restaurants probably should not be exempt, because a significant amount of value is added in the preparation of the food. The same argument can be made for highly processed foods sold at grocery stores. Attempting to identify clearly those foods which should be exempt and those which should be taxed can provide unusual results, however.[100] Rather than selecting individual food products from the VAT base, it may be advisable to develop a uniform rule by which the taxability of a food item could be determined. Under the Texas sales tax statute, food is exempt unless

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[98] William Trombley, *The Rising Price of Higher Education* (2003), http://www.highereducation.org/reports/affordability_supplement/affordability_1.shtml (analyzing the trend of decreasing state funding for public universities and the concurrent increase in tuition charged by these institutions).

[99] Jim Kuhnhenn, *Obama Decries Rising Cost of College Education,* YAHOO! NEWS, Jan 27, 2012, http://news.yahoo.com/obama-decries-rising-cost-college-education-152613213.html (describing President Obama's plan to limit tuition increases at institutions of higher education).

[100] This is Money, *Vat Rise: What Supermarket Food Is Exempt?* (June 23, 2010), http://www.thisismoney.co.uk/money/bills/article-1696467/VAT-rise-What-supermarket-food-is-exempt.html (identifying issues with the UK VAT, which taxes chocolate covered cookies and potato chips, but excludes chocolate chip cookies and corn chips).

specifically included in the sales tax base.[101] The statute subjects any food items that are prepared or are ready for immediate consumption, other than baked goods, to the VAT.[102] Under this definition, restaurants, prepackaged meals and processed foods would all be subject to VAT.[103] However, this construction narrows the tax base to an impermissibly high degree. Under an ideal VAT system, only raw fruits, vegetables, meats, bread and milk (the fundamental elements of the food pyramid) should be tax exempt, effectively promoting the social concerns of healthy nutrition while addressing the regressive nature of the VAT.[104] [105]

Raw fruits, vegetables, meats, and milk would likely evade the VAT for the most part; however, another issue arises in attempting to implement this system with regard to bread. Although the bread itself is exempt from the VAT, the flour, yeast, and services of the baker in preparing the bread are not exempt. As a result, the price of bread to the retailer is imbedded with the VAT imposed on the ingredients. Ultimately, consumers continue paying a significant portion of the VAT indirectly and avoid only tax on the amount of value added by the retailer. Administrative burdens make it impracticable to exempt only flour used for the production of bread, but to impose the VAT on that used for cakes and doughnuts. Even if it were possible to

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[101] 34 Tex. Admin. Code §3.293.

[102] *Id*. (defining food ready for immediate consumption as "Food, drinks, or meals prepared, served, or sold by restaurants, lunch counters, hotels, cafeterias, or other like places of business, that, when sold, require no further preparation by the purchaser prior to consumption, and food sold through vending machines").

[103] *Id*.

[104] Untied States Department of Agriculture, *The Food Guide Pyramid* (Apr. 21, 2012), http://www.nal.usda.gov/fnic/Fpyr/pmap.htm (prescribing 2-3 servings of dairy and meat, 3-5 servings of vegetables, 2-4 servings of fruit, and 6-11 servings of bread daily as part of a balanced, nutritional diet).

[105] A discussion of water has been omitted from this analysis. Under an ideal system, water supplied by municipal utility districts and water utility companies to residential properties for human consumption would be excluded from the VAT, whereas that supplied to residential properties for irrigation and other nonessential uses would be taxable. Water supplied to commercial properties would also be subject to the VAT. Several compliance and administrative issues arise in implementing this policy, but positing potential solutions to these issues is beyond the scope of this article.

Back to Table of Contents

track the ingredients as they progress along the value chain and ensure that they were being used for an exempt purpose, the recordkeeping would be unduly burdensome.

Zero-Rating Goods and Services

The solution to the issue presented is to implement a zero-rating policy, rather than a general exemption.[106] Similar to an exempt good, sellers of a zero rated good are not required to charge or remit VAT.[107] In addition to avoiding this obligation, sellers of zero rated products also receive a tax credit for VAT paid to and by their suppliers.[108] By compensating the retailer, the VAT paid at earlier stages in the process is removed from the cost of the bread.[109] Although it may seem redundant to require the producers of the ingredients to collect taxes only to refund them at the retailer level, this method ensures that only items which the taxing authority wishes to exclude from the tax base avoid taxation. Though this issue is most easily seen with the example of bread, it also impacts other items to be excluded from the VAT base. Raw fruit, vegetables, meat, and milk typically require some sort of packaging to be sold and must be delivered to the retailer for sale. These ancillary goods and services also incur VAT, though to a lesser degree than direct taxation of the ingredients of a product. As such, sound policy would seem to dictate that all items which are to be excluded from the VAT base be zero-rated. However, this may not be the case with regard to housing.

Unlike the other items to be excluded from the VAT, homes are long-term tangible assets. Whereas food is purchased for immediate consumption, residential properties can be held

[106] Eric Toder et al., *Implications of Different Bases for a VAT* (Feb. 2012), http://www.urban.org/uploadedpdf/412501-Implications-of-Different-Bases-for-a-VAT.pdf (explaining the effects of exemptions and zero ratings on the VAT).

[107] *Id* at 7.

[108] *Id*.

[109] *Id*.

for decades with little economic depreciation, despite having a 27.5 year life for tax purposes.[110] The land on which residential structures are built has an indefinite useful life and has the ability to increase significantly in value.[111] The purchase of homes is an investment in property, regardless of whether the purchaser intends to live in the property or to rent it out to supplement his income. As such, a purchase of residential property should not be exempt from the VAT, let alone zero rated. Construction of residential properties requires large amounts of raw materials and labor. Zero rating these properties would narrow the tax base to a great degree.[112]

Rent, on the other hand, may be better served zero-rated. The rate of home ownership rises proportionally with household income.[113] By zero-rating rent and not home purchases, the benefits may better target lower income households. Although there may be an equity argument put forth by high income taxpayers, it can easily be rebutted. Households who own their homes would not be taxed on the imputed rental value of their primary residence, they are only to be taxed on the initial purchase of the home.[114] As such, they receive the same benefit from the exclusion of rent from the VAT base as do lower income taxpayers.

However, this solution is anything but optimal. High income taxpayers who choose to rent luxury apartments rather than purchase homes may be able to avoid some VAT. It may be possible to zero-rate rent only on non-luxury housing, but the delineating issue of how to define housing as "luxury" arises. The taxing authority could propose a baseline rent amount above

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[110] Rev. Proc. 87-56 (providing a 27.5 year depreciable like for residential rental properties).

[111] *See* Satya Poddar, *Taxation of Housing Under a VAT*, 63 TAX L. REV. 443 (2010) (discussing the issues faced in applying the VAT to rent and to the purchase of residential properties).

[112] Applying this reasoning to other capital assets such as stock may not be administratively feasible.

[113] Economic Policy Institute, *Homeownership and Higher Incomes Go Together* (Jan. 7, 2011), http://stateofworkingamerica.org/charts/homeownership-rates-by-income-quartile-2009/ (showing homeownership rates by income quartile as of 2009).

[114] *See* Poddar, *supra* n. 111, at 445.

which rent would be considered luxury. Housing costs vary widely across the United States and even across cities, so the baseline amount would have to be adjusted for each locale.[115] Housing costs are also subject to rapid change as a result of the constantly evolving economy.[116] As such, adjustments to the baseline rent amount would have to be reevaluated on a periodic basis to ensure that they accurately reflect current economic conditions. The administrative burdens of implementing and maintaining this policy would be significant, but would be necessary to ensure that regressivity is properly addressed.

Zero-Rating Entities

Similar to such treatment of goods and services, taxing authorities also have the option of zero-rating entities. This may be the proper approach when dealing with healthcare and education. The delineation between taxable and tax-exempt goods may provide results counter to the tax objectives. Rather than identifying specific healthcare and education related products to exempt from the VAT, the government could simply exclude all goods and services provided by select, zero rated hospitals and schools. The issue then becomes determining which hospitals and educational institutions should be zero rated.

Rather than creating a new set of guidelines by which to make this determination, it may be possible to apply existing provisions of the Internal Revenue Code. Specifically, taxing authorities can zero rate all hospitals and educational institutions that qualify as charitable organizations under I.R.C. Sec. 501(c)(3) or those that qualify as governmental units as defined

[115] United States Census Bureau, *Renter-Occupied Housing Units--Gross Rent by State: 2009* (May 2011), http://www.census.gov/compendia/statab/2012/tables/12s0997.pdf (showing the range of rent costs across all fifty states).

[116] Jill Schlesinger, *House Prices Plunge: Recovery in 2013?,* CBS NEWS, May 9, 2011, http://www.cbsnews.com/8301-505123_162-38043979/house-prices-plunge-recovery-in-2013/ (stating that housing prices doubled from 2000 through 2006 and have dropped thirty percent from 2006 through 2011).

by I.R.C. Sec. 170(c)(1).[117] By zero rating only those institutions which are operated by the government or by third parties for nonprofit purposes, the regressive impacts of the VAT may be diminished while the tax base remains relatively intact.

An issue arises in implementing this policy because government and non-profit hospitals are not established to serve solely low income taxpayers. The medical services provided by these hospitals are made available to all taxpayers regardless of income level, thus extending the benefits of VAT-free medical services to high income taxpayers and reducing the effectiveness of this policy in reducing regressivity. Targeting low income taxpayers to receive tax-free medical services while imposing the VAT on high income taxpayers poses significant challenges. It may be unconstitutional to segregate hospitals by forcing them to cater only to individuals within certain income levels. Although feasible, it would be impractical and create a huge compliance burden to require patients to present proof of income each time they request medical attention. As such, zero-rating all government and non-profit hospitals may be the best option, outside of a major overhaul in federal healthcare regulation.

An expansion of government transfer payments may provide a viable alternative, given the issues presented by zero rating hospitals. Healthcare services paid for by Medicaid and Medicare should not be subject to the VAT because it creates an unnecessary compliance burden. The government would be transferring the VAT to the healthcare suppliers only to have them remit the taxes to the government. Prior to the passage of the Patient Protection and

[117]I.R.C. §501(c)(3) defines charitable organizations as those that are organized and operated exclusively for exempt purposes (including charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competition, and preventing cruelty to children or animals) and whose earnings do not inure to any private shareholder or individual. IRC §170(b)(1)(A)(v) defines governmental units as a state, a possession of the United States, or any political subdivision a state or possession of the United States, or the United States or the District of Columbia.

Affordable Care Act, the discussion in Congress included significantly expanding Medicare and Medicaid as well as providing low income taxpayers with the option of purchasing subsidized health insurance directly from the federal government.[118] By excluding payments made by the proposed federal insurance programs from the VAT, the tax relief would directly target low income taxpayers. High income taxpayers would not be eligible for the subsidized government insurance. As such, they would still be subject to the VAT either directly, on medical expenses they pay for out of pocket, or indirectly, through higher private insurance premiums.

Some consumers may feel that the medical care received at zero-rated hospitals or from those that accept only government transfer payments is inferior to that received at private hospitals. There may be some truth to the argument that expensive private hospitals can lure away the best doctors because they can afford to pay more than government and nonprofit hospitals. However, the objective of zero rating hospitals and providing government transfer payments is not to provide every citizen with the best doctors money can buy. The objective is to reduce the regressive effects of the VAT by removing the tax from goods and services that are required for a reasonable standard of living. The ability to visit the private doctor of one's choice is a luxury and should be taxed as such.

The right to choose may not be quite as meaningful with regard to education. While there are many fine public education institutions in the United States, the most highly regarded are

[118] Shailagh Murray, *House Health-Care Reform Bill Includes Public Option, Medicaid Expansion*, WASHINGTON POST, Oct. 20, 2009, available at http://www.washingtonpost.com/wp-dyn/content/article/2009/10/28/AR2009102804756.html.

typically private schools.[119] However, many of these private schools are structured as 501(c)(3) organizations and would be zero rated under the policy prescribed.[120]

Although this reasoning may be valid for those who chose to pursue a college education, it may not apply to those who choose other forms of post-secondary education. The majority of vocational schools, for example, are for-profit institutions. Given that most low income taxpayers are more likely to go to a vocational school than obtain a college education, the regressive impacts of the VAT are not effectively tempered by zero rating 501(c)(3) educational institutions.[121] It can be argued that the tax implications may induce more low income taxpayers to obtain a college education and, in turn, earn greater incomes over their careers. However, people do not necessarily make career decisions based purely on economic realities. Personal interests play a major role in the career path a person chooses. As such, many people may be forced to endure the additional VAT burden in order to pursue their passions, rather than go into a field in which they have no interest.

The same logic with regard to government transfer payments for healthcare applies to those for education. Educational expenses paid for by Pell grants and other government subsidies should not be subject to VAT. Thus, in order to effectively reduce regressivity with respect to education, the government could expand educational subsidies and grants to provide vocational

[119] U.S. News & World Report, *National University Rankings* (2012), http://colleges.usnews.rankingsandreviews.com/best-colleges/rankings/national-universities# (ranking the top ten universities, all of which are private institutions).

[120] John D. Colombo, *Why is Harvard Tax-Exempt? (And Other Mysteries of Tax Exemption for Private Educational Institutions)*, 35 ARIZ. L. REV. 841 (1993) (discussing the justification for treating private universities as tax-exempt educational entities under IRC §501(c)(3)).

[121] Jo Blanden et al., *Education and Family Income* (May 2002), http://personal.lse.ac.uk/machin/pdf/Education%20and%20Family%20Income%20Stoke%20Rochford%20Final%20Version.pdf (discussing the positive correlation between family income and children's level of educational attainment).

training to low income taxpayers. An alternative to this method would be to zero-rate all educational institutions, regardless of whether or not they are operated for a profit, but this option would significantly narrow the VAT base and may not be advisable.

Multiple Rate VAT Structure

In addition to exemptions and zero ratings, taxing authorities can also implement a multiple rate VAT structure.[122] The basic concept is that the VAT can be made more progressive by imposing higher rates of VAT on luxury goods and lower rates on ordinary household items. The average citizen is unlikely to purchase a private yacht or a Rolex watch. By imposing a 20% VAT on luxury items in contrast to a 5% rate on household items, higher income taxpayers who are more likely to purchase luxury items would increase the amount of VAT paid relative to their incomes. The higher rate does limit the ability of lower income taxpayers to splurge on these exotic items, but in all likelihood, most taxpayers are not going to be concerned with this limitation. The greater concern lies in the administrative and compliance burdens that arise from implementing a multiple rate structure.[123] Companies must properly categorize goods and services in order to charge the proper amount of VAT. The administrative burden taxing authorities would face in auditing VAT transactions would surely increase if, in addition to verifying their other VAT calculations, they were required to determine that the products had been properly classified.[124]

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[122] *See* Ine Lejeune, *The EU VAT Experience: What Are the Lessons?*, 63 TAX L. REV. 257 (2010) (stating that Denmark is the only EU nation to implement a single rate VAT).

[123] *Id*. at 276.

[124] *Id*. at 277 (stating that a multiple rate VAT structure would lead to greater disputes between taxpayers and taxing authorities as to the correct application of different rates).

When trying to implement a multiple rate structure, the issue of classifying goods as luxury items presents itself. Rather than identifying specific products as luxury items, the taxing authority could create a list of all the classes of products purchased by consumers and place reasonable values per unit on each of the classes. Any products priced above the reasonable value provided in the government listing would be subject to a higher rate of tax. An alternative would be to identify certain retailers as luxury retailers based on the price of their products in relation to that of substitutes. Under either method, a multiple rate structure would have significantly higher administrative and compliance costs than a single rate structure.

Although properly structured exemptions, zero ratings and multiple rates may alleviate the regressive effects of the VAT to some degree, they create a significant problem. Erosion of the tax base is widely seen as the biggest problem with the VAT as it is currently implemented in European nations.[125] When taxing authorities exclude certain items from the tax base, other industries begin clamoring for exclusions of their own. In countries where officials are elected by popular vote, there may be some erosion attributable to politicians pandering to their constituents. This problem may be exacerbated in the United States, given the exorbitant amount of money expended on lobbyists in this country.[126] Exclusions may be a viable option if it could be ensured that lawmakers would be unable to expand the list of excluded items, but this may not be possible under the U.S. political system. The VAT would be quite difficult to change if

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[125] *Id*. at 274 (stating that the EU VAT has a relatively narrow tax base because of the prevalence of VAT exemptions).

[126] Ctr. for Responsive Politics, *Influence and Lobbying* (Apr. 21, 2012), http://www.opensecrets.org/lobby/top.php?indexType=i (listing the amount spent on lobbying by industries in the US, with the pharmaceutical, insurance, and utilities industries topping the list).

written into the Constitution, but it would be just as difficult to pass an amendment incorporating the VAT.[127]

The VAT Credit or Demogrant

Though it is widely accepted that exemptions and zero rated items would help reduce the regressive impact of the VAT, their effectiveness as well as their efficiency have been called into question.[128] Excluding necessities from the VAT is effective in reducing regressivity because low income taxpayers spend a larger portion of their income on these items.[129] However, as income increases, the amount spent on these items typically increases as well.[130] Though their proportional benefits are less, high income taxpayers receive a greater benefit from these exclusions in terms of actual dollars saved than low income taxpayers.[131] By providing the benefits of VAT exclusions to both high and low income taxpayers, the regressive effects are only nominally tempered.[132] Consequently, taxing authorities forego a significant amount of revenue by extending exclusions to high income taxpayers.[133] Narrowing the tax base in this manner is wasteful and unnecessary, but structuring exclusions in a manner through which only low income taxpayers' benefit would not be easily administrable.

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[127] U.S. CONST. art. V, § 1 (allowing for an amendment to the Constitution where both the U.S. House of Representatives and the U.S. Senate approve by a two-thirds supermajority vote, a joint resolution which is then ratified by either the state legislatures or conventions in three-fourths of the states).

[128] Eric Toder & Joseph Rosenberg, *Effects Of Imposing a Value-Added Tax to Replace Payroll Taxes or Corporate Taxes* (Mar. 18, 2010), http://www.taxpolicycenter.org/UploadedPDF/412062_VAT.pdf (finding that excluding housing, food consumed at home, and private health expenditures from the consumption tax base can somewhat increase progressivity, but not as much as a per-person payment).

[129] *See* Toder et al., *supra* n. 106, at 12.

[130] *Id*.

[131] *Id*.

[132] *Id*.

[133] *Id*.

A better alternative to exemptions may be to provide a demogrant to low income households as a direct refund of the VAT paid.[134] This credit should be structured in a manner which effectively redistributes the burden of the VAT from low income taxpayers to high income taxpayers. This may be accomplished by basing the amount of the credit on the annual income of the recipient household. The highest refund would be reserved for those with incomes below the poverty level. The maximum refund amount could be gradually phased out as household income rises, ensuring that low income taxpayers who bear the brunt of the regressive burden benefit the most.[135]

Although phase outs are already found in several places in the U.S. income tax regime, some issues arise with their implementation. The first issue is that phase outs increase marginal tax rates along the phase out range and decrease the after tax gains of earning more income.[136] Thus, taxpayers in the phase out range would be less inclined to increase productivity. Another issue is that several tax provisions phase out over the same range of income.[137] As a result, the effects of the phase outs are compounded and dramatically reduce the incentive to increase productivity. The negative impacts of phase outs may be reduced by increasing the income range over which the demogrant is phased out. However, as the phase out range of a tax provision is increased, higher income taxpayers are able to take advantage of its benefits. These two concerns must be balanced in determining the proper range over which to phase out the demogrant.

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[134] *Id*.

[135] The Urban-Brookings Tax Policy Ctr., *Income Tax Issues: How do Phaseouts of Tax Provisions Affect Taxpayers?* (Oct. 5, 2011), http://www.taxpolicycenter.org/briefing-book/background/issues/phaseouts.cfm.

[136] *Id*.

[137] *Id*. (describing the main phase ins and phase outs in the tax code as of 2011).

Back to Table of Contents

Although gross income has been defined for federal income tax purposes, income for the purpose of calculating the demogrant amount must be redefined.[138] Under the current tax code, government transfer payments, such as those from Social Security, are not taxable unless the taxpayer has a substantial amount of income from other sources.[139] For the VAT income calculation, however, Social Security payments should be included in the income of all taxpayers. When the federal government sets the amount of Social Security payments to be made each year, it factors inflation and other changes in the general price level of goods. With a VAT in place, the government would continue to adjust Social Security payments to reflect the increased cost of goods. By excluding Social Security payments from VAT income, taxpayers would receive a double benefit. The transfer payments already reflect the VAT impacts; by removing them from income the taxpayer would also receive a larger demogrant. As such, all income from whatever source derived should be included in the definition of income when calculating the demogrant, and no exclusions should be made.

Rather than using complex phase out provisions, taxing authorities may be better able to direct the demogrant to low income taxpayers by implementing a standard credit amount for each household.[140] Annually, the U.S. publishes poverty levels under which low income households can qualify for assistance under various federal programs.[141] These levels are adjusted on an annual basis to reflect inflation and other cost of living increases. Taxing authorities could

[138] I.R.C. §61states that gross income means all income from whatever source derived, except as otherwise provided in subtitle A.

[139] U.S. Social Security Administration, *Benefits Planner: Income Taxes and Your Social Security Benefits* (Apr. 4, 2012), http://www.ssa.gov/planners/taxes.htm (stating that social security benefits are taxable only if the taxpayers adjusted gross income plus tax exempt interest plus 50% of social security benefits exceed annually prescribed thresholds).

[140] *See* Toder et al., *supra* n. 136, at 26.

[141] U.S. Dept. of Health and Human Services, *2012 HHS Poverty Guidelines* (Feb. 9, 2012), http://aspe.hhs.gov/poverty/12poverty.shtml.

calculate the amount of the demogrant to be provided to each household by taking 300% of the poverty level for that household and multiplying it by the VAT rate.[142] The average annual pretax wage in the U.S. is $39,156 as of 2011.[143] By taking 300% of the poverty level as the baseline credit amount, we ensure that only households with earnings below the average annual wage receive the full benefit of the demogrant.

Under this method, all households of the same size would receive an equal demogrant, regardless of income. Unless they use debt to fuel further consumption, households living below the adjusted poverty line would get a demogrant in excess of the VAT they would have paid during the year.[144] Concurrently, high income households, which typically increase consumption as income increases, would receive the same amount of credit as those who fall right at the poverty line.[145] Thus, any household consumption above the annual adjusted poverty levels would be fully subject to the VAT.[146] This method effectively reduces the regressivity of the VAT by exempting all consumption up to the adjusted poverty level for all households and providing a rebate to those that fall below the adjusted poverty line.[147]

[142] Assuming a 5% VAT rate, under this methodology, the credits for 2012 would range from $1,675.50 for a single member household ($11,170 poverty level x 300% x 5% VAT rate) to $5,883.50 for an eight member household ($38,890 poverty level x 300% x 5% VAT rate) living in the contiguous states.

[143] http://www.bbc.co.uk/news/magazine-17543356

[144] *See* Toder et al., *supra* n. 136, at 27.

[145] *Id*.

[146] *Id*.

[147] *Id*.

Exempting Entities

In addition to exempting goods and services, taxing authorities can also exempt entities from the VAT.[148] Similar to the treatment of products, exempt entities would not impose the VAT on any of their sales, but also would not receive a credit for the VAT paid on their inputs.[149] As previously discussed, exemption does not lend itself to eliminating VAT from the products or entities to which it is applied. Exempt entities would merely avoid the burden of collecting and remitting the VAT, but the taxes already paid in its production process remain imbedded in the cost of the product.[150] Although exempting entities may not be the most effective method of alleviating regressivity, it may still prove useful as an administrative tool.[151]

The burden of participating in a VAT economy may not affect large companies or multinationals, but the impact on small businesses would be relatively significant.[152] Integrating into the VAT system and maintaining compliance would increase the overhead costs of startups and small businesses, making it harder for them to compete with large companies and creating an additional barrier to entry. To counteract this effect, taxing authorities could choose to exempt businesses with gross revenues below a threshold amount, allowing startups to gain some momentum before imposing VAT obligations on them.[153]

The revenue threshold exemption would not narrow the tax base as much as one would expect. Small businesses which function as suppliers to larger businesses would likely still pay

[148] *See* Gale et al., *supra* n. 4 at 72.

[149] *Id*.

[150] *Id*.

[151] *Id*.

[152] *Id*.

[153] *Id*. (stating that, as of 2007, 24 out of the 29 OECD countries with a VAT exempted businesses with gross receipts beneath specified thresholds).

Back to Table of Contents

the VAT under the credit invoice system even if they were not required to do so. Larger companies would avoid dealings with small companies who do not pay any VAT on their products because this burden would be inherited by the larger companies when they go to resell the products. As such, small businesses who wish to maintain supplier relationships with large companies would voluntarily comply with the VAT system. Although small retailers would be exempt from the obligation of collecting and remitting VAT, their suppliers and the manufacturers of their goods are likely to be large companies which are subject to the VAT obligations. This ensures that a significant portion of the VAT to be collected on the sales of these small retailers has already been imposed at earlier levels. The revenues lost from small retailers who primarily obtain their goods from small suppliers, all of whom elect to remain exempt, would be negligible.

Moreover, any revenue lost under the exemption, may have been lost even without the exemption. According to compliance studies, small businesses in the United States have extremely high noncompliance rates with regards to the income tax.[154] In addition, the U.S. Treasury estimated that the "compliance gap" for a U.S. VAT would be approximately 15%.[155] Thus, many of the small businesses who would be exempt under the revenue threshold would likely have evaded the tax anyway.

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[154] Eric Toder, *What is the Tax Gap?,* 117 TAX NOTES 367 (Oct. 22, 2007).

[155] *See* Toder et al., *supra* n. 106, at 12 (defining the compliance gap as the failure to pay tax in full and on time).

Back to Table of Contents

Stand Alone VAT

Many proponents of the VAT call for a complete repeal of the income tax. Others call for implementation of the VAT as a substitute for specified areas of the current tax regime.[156] Yet others call for the VAT as a revenue generator in addition to the current income tax structure to help fund existing government programs. In order to replace the income tax entirely, the VAT rate would have to be significantly higher than the 5% rate assumed for this paper.[157] Although studies have been conducted into the VAT rate required to eliminate the federal income tax, any estimated required rate may not be accurate and should be taken with a grain of salt. In estimating the appropriate rate to implement, the taxing authorities must make assumptions as to the change in consumer behavior as a result of the change in method of taxation. It would be extremely difficult to accurately predict consumer behavior in a scenario where taxpayers have higher take home income, but where goods cost significantly more. The higher take home pay may make consumers feel wealthier and more willing to spend or, conversely, the higher prices could make consumers feel less wealthy and more apt to save.

At any rate, the stand alone VAT may provide some benefits.[158] The consensus among economists is that the current income tax structure is economically inefficient.[159] In addition to causing frequent errors by the IRS and taxpayers, the complexity of the current income tax

[156] *See* Toder et al., *supra* n. 136 (examining the implementation of the VAT as a substitute for the payroll tax and the corporate income tax).

[157] Paul Bachman et al., *Taxing Sales Under the FairTax: What Rate Works?* (Nov. 13, 2006), http://www.fairtax.org/PDF/Tax%20Notes%20article%20on%20FT%20rate.pdf (estimating that a 23% national sales tax rate would generate enough revenue to eliminate the income tax).

[158] *See* Carroll & et al., *supra* n. 56.

[159] Chris Edwards, *Income Tax Rife with Complexity and Inefficiency* (Apr. 2006), http://www.cato.org/pubs/tbb/tbb-0604-33.pdf.

system impedes economic decision making and increases compliance costs.[160] These problems may be resolved by replacing the income tax with the VAT.

The income tax structure penalizes savers and investors because it taxes earnings on savings and investments.[161] Rather than investing and incurring additional tax liabilities, taxpayers may be more willing to spend and receive the immediate benefits of consumption. The tax code also creates distortions in economic decisions because it treats different forms of income differently.[162] By varying the tax rates imposed on differing types of income, investor behavior is inevitably influenced by tax policy. For example, high income taxpayers may be more willing to invest in tax-exempt municipal bonds than in REIT's whose distributions are taxed at ordinary income rates. In moving to a VAT system, consumer behavior would be more pure in the sense that consumer actions would not be based on the potential tax implications. This unadulterated consumer behavior would move the U.S. economy closer to the idealistic definition of capitalism. However, consumer behavior may still reflect some tax considerations in a VAT system that uses exclusions to reduce regressivity. Consumers may begin to substitute goods subject to the VAT with comparable goods that are excluded, illustrating the importance of maintaining a wide VAT base and limiting the availability of tax-free substitutes to the greatest extent possible.

Replacing the tax code entirely in favor of the VAT would also lead to a simplification of the tax system and, in turn, reduce compliance and administrative burdens.[163] Taxpayers would

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160 *Id*.

161 *Id*.

162 *See* Carroll et al., *supra* n. 157, at 1120.

163 *Id*. at 1121.

no longer need to parse through the complicated tax code in order to file their annual income tax returns.[164] Households would simply need to report the number of persons in their household so as to determine the size of the demogrant to which they would be entitled.

Businesses would face the slightly higher compliance burden imposed by the need to calculate and remit the VAT collected on a periodic basis. The frequency of these remittances, however, can be structured in a manner which minimizes the burden. Similar to existing state sales tax regimes, the frequency should be determined by the VAT collections of the remitting company.[165] Small companies with lower amounts of tax to be remitted would be eligible to make annual or quarterly remittances, whereas larger companies with higher amounts of tax to be remitted would be required to make remittance on a monthly basis. This reduces the compliance burden for smaller companies, while ensuring that the government is still receiving a large portion of the taxes collected in a timely manner. Although businesses would be required to file more frequently under the VAT system than the current income tax system, the complexity of these filings would be significantly lower under the VAT system.

Without the complexity of determining the character and timing of income as required by the current tax code, compliance would be significantly easier. This would lead to a reduction in the estimated $265 billion spent annually on record keeping, learning tax rules and related activities.[166] At the same time, the taxing authority would be able to regulate and administer the

[164] *Id*.

[165] Texas Comptroller of Public Accounts, *Texas Sales Tax Frequently Asked Questions* (Apr. 26, 2012) http://www.window.state.tx.us/taxinfo/sales/faq_report.html#report2 (stating that Texas entities are required to remit sales tax monthly, quarterly or annually depending on the amount of tax collections).

[166] *See* Edwards, *supra* n. 158.

Back to Table of Contents

tax more easily.[167] According to the IRS, the total compliance and administrative costs of the current income tax system equal nearly $52 billion annually.[168] By contrast, the total compliance and administrative costs of the VAT system are estimated to range from approximately $5.8 to $8.8 billion annually.[169] The cost savings make a complete repeal of the current tax code in favor of the VAT seem quite inviting, but there are hurdles to clear.

The primary issue with the decision to replace the federal income tax is the impact on state and local governments.[170] Most states calculate their income taxes by starting with the taxpayer's federal taxable income and making some adjustments to arrive at the taxable income allocated to that state.[171] If the federal income tax were repealed, the states would either have to engineer their own tax codes to maintain an income tax or piggyback onto the federal VAT by imposing a state VAT.[172] If the states choose to maintain independent income tax regimes, the gains in simplicity and ease of compliance attributed to the VAT may be counteracted.[173] It may be more beneficial for states to simply replace their income tax systems and piggyback onto the federal VAT.

[167] *Id*.

[168] *See* Carroll et al., *supra* n. 157, at 1121 (stating that the current income tax system generates approximately $40 billion in tax preparation costs annually, in addition to the $12 billion annual IRS budget).

[169] *Id*. (estimating that the administrative costs of a fully phased in VAT system would be approximately $1.8 billion, in addition to annual compliance costs ranging from $4 billion to $7 billion).

[170] *Id*.

[171] *Id.*

[172] *Id.*

[173] *Id.*

The VAT with the Progressive Income Tax Structure

If the VAT is imposed in addition to the income tax structure currently in place, the combined system may actually create a more proportional tax structure. The regressive nature of the VAT would offset the progressive nature of the income tax. However, given the recent Occupy Wall Street movement, it would be safe to assume that there would be a large public outcry if lawmakers attempted to pass a clearly regressive tax with the argument that our current tax system is too progressive.[174] Rather, lawmakers must show that they are making a concerted effort to reduce the regressivity of the VAT. This can be done using a couple of methods.

Under the first method of addressing regressivity, taxpayers can be given a deduction from their federal taxable income for VAT paid. This may be accomplished in a manner similar to the current treatment of state sales and income taxes.[175] Under the current system, taxpayers are allowed to take an itemized deduction for the amount of state income taxes paid. If the taxpayer lives in a state which does not impose an income tax, he has the option to deduct an amount equal to either the actual sales tax paid for the year or a standard amount calculated based on adjusted gross income.[176] There are two issues with maintaining this treatment for the VAT. The first issue is that the sales tax deduction is currently allowed only to those who itemize deductions, a system that is to some degree regressive. All taxpayers are granted the standard deduction, but only those with itemized deductions that exceed the standard deduction are able to take advantage of them. Higher income taxpayers are more likely to itemize because they are

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[174] Alan Taylor, *Occupy Wall Street*, THE ATLANTIC (Sept. 30, 2011), http://www.theatlantic.com/infocus/2011/09/occupy-wall-street/100159/# (describing the Occupy Wall Street movement as rallies and demonstrations against corporate greed, and, financial and social inequality).

[175] I.R.C. §164(b)(5) allows a deduction for "general sales taxes" and defines a general sales tax as "a tax imposed at one rate with respect to the sale at retail of a broad range of classes of items."

[176] *Id*.

more likely to pay home mortgage interest, property taxes and other qualifying deductions. Given that few low income taxpayers are able to take itemized deductions, the VAT deduction would likely be unavailable to the taxpayers for whom it is intended. Another issue arises with the way the sales tax deduction is currently calculated. The deduction increases as the taxpayers' adjusted gross income increases, distributing the benefits of the VAT deduction in a similar manner would disproportionately benefit high income taxpayers. One way of addressing these issues is to calculate the allowable VAT deduction by allowing a base amount that decreases as income increases and adding this amount to the standard deduction.

As an alternative, the personal exemption amount can be increased to adjust for the VAT. The benefit of increasing the personal exemption is that it is already designed with progressivity in mind. As a taxpayer's adjusted gross income moves above a threshold amount, the personal exemption is gradually phased out.[177] By increasing the personal exemption, low income taxpayers would receive the benefit of a higher deduction, and high income taxpayers would not. The issue with increasing deductions, either through personal exemptions or the standard deduction, is that VAT deductions benefit only taxpayers with taxable income. Low income taxpayers that do not have any income tax liability would not receive any benefit from an additional deduction.

The second method of addressing the regressivity of the VAT involves providing a demogrant or a tax credit for low income taxpayers.[178] Congress could distribute the demogrant by passing legislation to expand the earned income tax credit. By expanding the earned income

[177] *See* The Urban-Brookings Tax Policy Ctr., *supra* n. 143 (stating that the phase out of the personal exemption has been suspended through 2012, but is expected to be reinstated beginning in 2013).

[178] *See* Toder et al., *supra* n. 106, at 12.

credit, the benefits of the tax credit phase out as income rises.[179] Although this method may target greater benefits to low income taxpayers, it also creates significantly high marginal tax rates along the phase out range. A better method would be to provide a standard credit based on the size of the taxpayers' household, as discussed in the previous section. This credit would be relatively easy to administer under the current income tax system because taxpayers already file tax returns which list their dependents. It would not require much additional effort to determine the amount of the credit with this information readily available.

Under either method, the transition from the current system into one which incorporates a VAT component would cause significant problems.[180] The first issue is one of asset valuation. Adding on a new VAT would decrease the value of existing assets by approximately the same rate as the VAT.[181] Future consumption can be equated to the sum of future wages earned and the fair market value of currently held assets.[182] These assets would be subject to the VAT when consumed and have inherently less purchasing power than they did prior to the adoption of the VAT.[183] For example, take a taxpayer who has $1,000 in a bank account prior to the imposition of a 5% VAT. Once the VAT is implemented, the taxpayer would need $1,050 in order to purchase the same items which he could have purchased for $1,000 prior to the VAT being

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[179] *See* The Urban-Brookings Tax Policy Ctr., *supra* n. 143 (stating that the earned income credit for 2011 phases out from $7,590 to $49,087 depending on filing status and number of children).

[180] *See* Carroll et al., *supra* n. 157, at 1122.

[181] *Id.*

[182] *Id.*

[183] *Id.*

imposed. Although the transition would result in significantly higher amounts of revenue, it may be viewed as unfair by the general populace.[184]

This double taxation can be alleviated by providing taxpayers with a VAT credit equal to the value of their existing assets multiplied by the VAT rate. Making this credit fully refundable would likely bankrupt the federal government. Rather it could be treated as a non-refundable credit which would offset the income tax liability to the extent of VAT actually paid during the year. Any credit not used in the initial year could be carried over for a period of ten years in order to gradually phase in the VAT. However, implementation of this credit would be deeply regressive. Higher income taxpayers would possess significantly higher amounts of assets at the time the VAT is introduced. As such, the credit would disproportionally benefit high income taxpayers. Given the current economic climate, it may be more feasible to convince taxpayers that this transition effect would be a one-time occurrence and the brunt of the burden would be borne by high income taxpayers who hold significant amounts of assets.

Conclusion

The VAT appears to be a viable solution to the fiscal crisis facing the United States, but careful consideration must be taken to ensure that it is implemented properly. The U.S. should adopt the credit invoice method VAT primarily for its ease of administration relative to the subtraction method. The credit method also allows the U.S. to maintain uniformity with its principal trading partners and allows the taxing authority the option to impose multiple VAT rates.

[184] *Id.*

Back to Table of Contents

The Regressive Monster
Resolving Issues With The Value Added Tax

Although proponents argue that the VAT is a proportional tax, in practice, it is actually a regressive tax. The VAT is vertically inequitable because high income taxpayers, unlike low income taxpayers, may be able to avoid the VAT by choosing not to consume all of their incomes. It is also horizontally inequitable because consumption varies widely among high income taxpayers. In order to promote tax equity, the VAT must be structured in a manner that reduces its regressive effects.

The regressivity of the VAT may be addressed by using exclusions such as exemptions, zero-ratings and multiple VAT rates or by providing demogrants to low income taxpayers. Exemptions are not very effective in reducing regressivity because they remove only a single level of VAT on a product. When a product is exempt from the VAT at the retail level, it still has the VAT paid on all the prior stages of production imbedded in its sales price. Although exemptions do little to reduce regressivity, exempting small companies from the VAT may be effective in reducing the compliance burden while having only a nominal effect on tax collections.

The ineffectiveness of VAT exemptions in addressing regressivity can be overcome by implementing zero-ratings instead. If a zero rating system is to be implemented, the policy should be designed to remove the VAT from essential items such as raw fruits, vegetables, meats, bread, and milk. Given that low income taxpayers are less likely to own their homes, rent should also be zero rated. However, significant issues arise in zero rating rent in a manner that targets low income taxpayers.

Education and healthcare are also fundamental to achieve a reasonable standard of living. The taxing authority can opt to zero rate government and non-profit entities operating in these

Back to Table of Contents

sectors. It also has the option of expanding government transfer payments in these areas and excluding educational and healthcare services purchased using these transfer payments from the VAT base. Again, significant administrative issues arise in utilizing these options. In general, VAT exclusions and other multiple rate structures are inefficient and may unnecessarily narrow the tax base.

The most efficient way to address the regressivity of the VAT would be to use a demogrant which functions as a direct payment issued to every American household. The amount of the demogrant would be equal to the VAT rate multiplied by 300% of the annual poverty level for each household. Under this method, the size of the demogrant would increase along with the size of the household. All households with the same number of members would receive equal payments, regardless of income level. As such, the demogrant effectively eliminates the effects of the VAT on all consumption up to the adjusted poverty level, while taxing all consumption in excess of the adjusted poverty level.

Many proponents of the VAT endorse replacing the current income tax system with the VAT. Although it would likely lead to a simplification of the tax system and reduced compliance and administrative burdens, it would not be easy to replace the revenues generated from the current tax regime with only the VAT. Determining the tax rate at which VAT revenues would equal those from our current income tax regime would prove to be a challenge. Such a massive tax overhaul would have unpredictable impacts on consumer spending behavior, thereby limiting the ability to accurately estimate the revenues that would be generated at any given VAT rate.

The ideal tax system would implement the VAT as an overlay to the progressive income tax system currently in place. Although the added VAT would increase administrative costs, the additional revenues generated would more than outweigh the costs incurred. In order to address the regressivity added by the VAT, the system should institute a demogrant which provides every household with a standard credit amount based on its size. The demogrant would be relatively easy to administer under the current income tax regime because taxpayers are already required to file tax returns which list all of their dependents. By implementing this system, the government has a legitimate solution to its fiscal problems. The administrative costs of this system are a small price to pay for a broad based VAT with limited regressive effects.

Back to Table of Contents

REPEALING OIL AND GAS TAX SUBSIDIES: A TAXATION ANOMALY AND ALTERNATIVE ENERGY BARRIER

TABLE OF CONTENTS

I.	INTRODUCTION	2
II.	HISTORICAL AND CURRENT POLICIES BEHIND THE OIL AND GAS TAX SUBSIDIES	4
III.	OIL AND GAS TAX SUBSIDIES	7
	A. Percentage Depletion	7
	B. Intangible Drilling Costs	9
	C. Domestic Manufacturing Activity	10
	D. Geological and Geophysical Expenses	11
	E. Passive Loss Exception for Working Interests	13
	F. Deductions for Tertiary Injections	13
	G. LIFO Inventory Accounting	14
	H. Credit for Enhanced Oil Recovery Costs	15
	I. Credit for Enhanced Oil Recovery Costs	15
	J. Marginal Well Tax Credit	16
IV.	GENERAL ECONOMIC AND ENVIRONMENT CONSIDERATIONS IN REPEALING SUBSIDIES	16
V.	THE REPEAL OF SPECIFIC SUBSIDIES	24
	A. Percentage Depletion	24
	B. Intangible Drilling Costs	27
	C. Domestic Manufacturing Activity	28
	D. Geological and Geophysical Expenses	30
	E. Passive Loss Exception for Working Interests	35
	F. Deductions for Tertiary Injections	36
	G. LIFO Inventory Accounting	37
	H. Credit for Enhanced Oil Recovery Costs	38
	I. Credit for Enhanced Oil Recovery Cost and Marginal Well Tax Credit	39
VI.	CONCLUSION	39

I. INTRODUCTION

Tax deductions and subsidies are a way for the government to encourage greater risk-taking behavior by sharing in the risk of loss with taxpayers.[1] In other words, a tax subsidy is "a specific tax provision that is deliberately inconsistent with an identifiable general rule of the present tax law . . . and that collects less revenue than does the general rule."[2] Subsidies such as these are also called "tax expenditures," defined as losses in revenue from federal income that the government could be receiving.[3] According to calculations by the Joint Committee on Taxation, tax expenditures increased from $36.6 billion in 1967[4] to $1 trillion in 2007[5]. More specifically, the U.S. has foregone $32.3 billion in revenue between 2007 and 2011 due to favorable oil and gas tax deductions.[6] And, without intervention, oil and gas industries will continue to benefit up to $40 billion from tax breaks in the next decade.[7]

During the first three months of 2011, Exxon earned approximately $10 billion, a 69 percent increase in earnings.[8] Society should juxtapose those earnings against a federal government that is heavily in deficit and continues to cut spending.[9] One cannot help but wonder

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[1] Michael Livingston, *Risky Business: Economics, Culture and the Taxation of High-Risk Activities*, 48 TAX L. REV. 163, 168 (1993).
[2] JOINT COMM. ON TAXATION, 110TH CONG., A RECONSIDERATION ON TAX EXPENDITURE ANALYSIS 9 (2008).
[3] *Id.*; MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION PRINCIPLES AND POLICIES 43 (6th ed. 2009).
[4] CONG. BUDGET. OFFICE, TAX EXPENDITURES: BUDGET CONTROL OPTIONS AND FIVE-YEAR BUDGET PROJECTIONS FOR FISCAL YEARS 1983-1987 12 tbl. 3 (1982), *available at* http://ww.cbo.gov/doc.cfm?index=5940&type=1.
[5] Roberta Mann, *Back to the Future: Recommendations and Predictions for Greener Tax Policy*, 88 OR. L. REV. 355, 400–01 (2009).
[6] *Id*. at 403.
[7] Jim Zarroll, *As Gas Prices Rise, Oil Company Tax Breaks Debated*, NPR (Apr. 28, 2011, 6:50PM), http://wap.npr.org/news/Business/135804737?singlePage=true.
[8] *Id*.
[9] *Id*.

if oil and gas companies are paying their fair share of taxes.[10] Especially in this economic atmosphere, the purpose behind financially benefiting certain industries through tax breaks should be compelling.[11]

This Comment discusses which oil and gas tax subsidies should be repealed and why.[12] The Comment concludes that all but one oil and gas tax subsidy should be repealed because the subsidies encourage inefficient spending and investment.[13] In addition, the Comment argues that subsidies no longer support their original purposes, as the global market will continue to support demand for oil and gas even after the repeal.[14] And lastly, subsidies disrupt the alternative energy agenda by skewing investment further in favor of oil and gas.[15] Geological and geophysical deductions, however, should not be repealed.[16] This Comment will even support a more beneficial deduction, instead of an amortized schedule, because advances in research will counter the disadvantages of repealing other subsidies.[17]

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[10] *Id.*
[11] *See id.* (Republican House Speaker John Boehner . . . in his interview with ABC. "We're in a time when the federal government is short on revenues," he said. "We need to control spending, but we need to have revenues to keep the government going. And [oil companies] ought to be paying their fair share.")
[12] *See infra* Parts III–V.
[13] *See infra* Parts IV.A-I, IV.D (arguing that all oil and gas subsidies should be repealed except for deductions for geological and geophysical research).
[14] *See infra* Parts IV.A-I, IV.D (arguing that all oil and gas subsidies should be repealed except for deductions for geological and geophysical research).
[15] *See infra* Parts IV.A-I, IV.D (arguing that all oil and gas subsidies should be repealed except for deductions for geological and geophysical research).
[16] *See infra* Part IV.D (arguing that geological and geophysical deductions should not be repealed because their success will alleviate the negative consequences of tax repeal, by continuing to increase supply and lower costs).
[17] *See infra* Part IV.D (arguing that geological and geophysical deductions should not be repealed because their success will alleviate the negative consequences of tax repeal, by continuing to increase supply and lower costs).

These solutions can serve to meet the agenda of all parties – creating a more fair and efficient tax system.[18] In concurrence, oil and gas industries are granted a concession that provides an incentive to continue developing innovative and efficient energy solutions.[19] The information and arguments presented can also be applied in consideration of repealing similar tax subsidies for other resources such as timber[20] and minerals.[21]

II. HISTORICAL AND CURRENT POLICIES BEHIND THE OIL AND GAS TAX SUBSIDIES

In the 1970s, oil and gas companies were subsidized for two primary reasons: the first was independence from foreign oil, a value formed during the country's difficulty in coping with the Arab Oil Embargo of 1973,[22] and the second was to support a "fledgling industry" during times of unstable prices.[23] While the oil and gas industry has been subject to many ups and

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[18] *See supra* Part III (arguing that one of the reasons for repealing most of the oil and gas subsidies is to create a "fairer" tax system).
[19] *See supra* Part IV.D (arguing that encouraging geological and geophysical research allows oil and gas companies to find other methods to increase supply and lower cost).
[20] *See* John A. Bodgdanski, *Reflections of the Environmental Impacts of Federal Tax Subsidies for Oil, Gas and Timber Production*, 15 LEWIS & CLARK L. REV. 323, 328-37 (2011) (discussing similarities and arguments for the repeal of timber and oil and gas subsidies).
[21] *See generally* Jay Starkman, *The Debate Over Oil and Mineral Taxes*, 125 TAX NOTES 185, 189 (2011) ("[S]imilar treatment in varying percentages was afforded to the owners of iron, coal, sulfur, and metal mines.").
[22] *Domestic Oil & Gas – Tax Proposals to Increase Production: Hearing on S. 971 Before the Subcomm. On Taxation of the Senate Comm. on Finance*, 103d Cong. 172 (1994) (statement by Friends of the Earth), 94-95(((is this the correct formatting?))); *see also What Will the New Millennium Bring? :: Hearing on Energy Security Before the Subcomm. On Energy and Power*, Oct 2, 1998, *available in* 1998 WL 18089263, at *1 (statement of Jay Hakes, Administrator, Energy Info. Admin., Dep't of Energy) ("The importance of energy to the Nation, the importance of gas and oil in the energy mix, the development of cutting edge technology, and the creation of high-skill high-value jobs, makes the gas and oil industry very important to our country").
[23] Mona Hymel, *The United States' Experience with Energy Based Tax Incentives: The Evidence Supporting Tax Incentives for Renewable Energy*, 38 LOY. U. CHI. L.J. 43, 47–48 (2006).

Back to Table of Contents

downs, especially during times of war, those financial deviations were ephemeral.[24] Since the 1990s, the purpose for oil and gas subsidies has been refined to these three reasons: (1) to encourage oil and gas production and exploration in its beginning phase; (2) to compensate for the value differentiation between the private and public sector; and (3) to reduce financial risks and hazards related to oil and gas production.[25] This Comment discusses whether current oil and gas tax subsidies fulfill these purposes.[26]

In America, oil and gas exploration, production, and consumption is a large part of the economy.[27] The United States comprises only 4.5 percent of the world's population, yet it consumes over one quarter of the world's oil and gas.[28] Therefore, sixty percent of the country's oil and gas is imported to meet those needs.[29] Additionally, the oil and gas industry employs over nine million Americans.[30] Even so, the industry continues to grow as the world demand for oil

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[24] Carrie Cecil, *Budget Battles: Would the Obama Administration's Proposal To Eliminate Oil and Gas Tax Subsidies Injure the Industry?*, 8 PITT. TAX REV. 209, 213 (2011).
[25] Hymel, *supra* note 25, at 47.
[26] *See supra* Part VI–V (discussing whether oil and gas tax subsidies realize their purposes and if they do not they should be repealed).
[27] *See The World's Biggest Public Companies*, FORBES, (April 2011), http://www.forbes.com/global2000/list/#p_1_s_arank_All_All_All (listing ExxonMobil, Chevron, and ConocoPhillips as three of the top twenty-five largest public companies in the world.)
[28] *See COUNTRY COMPARISON:: POPULATION*, THE WORLD FACTBOOK (Oct. 29, 2010, 4:30 PM), *available at* https://www.cia.gov/library /publications/the-world-factbook/rankorder/2119rank.html; *U.S. Petroleum Supply, Consumption, and Inventories*, ENERGY INFO. ADMIN. (Oct. 29, 2011, 4:42 PM), *available at* http://www.eia.doe.gov/emeu/steo/pub/4atab.pdf; *World Petroleum Consumption*, ENERGY INFO. ADMIN. (Oct. 29, 2011, 4:42 PM), *available at* http://www.eia.doe.gov/emeu/steo/pub/3dtab.pdf; Safe, Strong and Secure: Reducing America's Oil Dependence, NATURAL RES. DEF. COUNCIL (Oct. 29, 2011, 4:42 PM), *available at* http://www.nrdc.org/air/transportation/aoilpolicy2.asp.
[29] *Basics*, THE SELECT COMM. ON ENERGY INDEPENDENCE AND GLOBAL WARMING (Oct. 29, 2011, 4:45 PM), *available at* http://globalwarming.house.gov/issues/energyindependence?id=0002.
[30] Zarroll, *supra* note 7.

reaches a new record in 2012[31] and domestic oil output reached its highest annual output since 2003.[32] These factors surmise that the oil and gas industry continues to make an impact, not only domestically, but internationally as well.

Another way that oil companies make an impact is through large political contributors.[33] For example, from 1991 to 1996, the oil and gas industry collectively donated over $50 million to the U.S. federal elections, mostly to Republican representatives.[34] This suggests that an obstacle to the repeal of certain oil and gas subsidies could be the industry's strong political clout.[35]The oil and gas industry is notoriously powerful and influential[36] – overcoming their political influence is potentially the greater challenge in repealing these tax subsidies.[37]

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[31] *US oil and gas M&A jumps in 2011,* BLOOMBERG BUSINESSWEEK (Feb. 8, 2012, 4:03 PM), http://www.businessweek.com/ap/financialnews/D9SPE6500.htm

[32] Some are considering this time period a "great revival" in domestic production. Mason Inman, *U.S. Oil Fields Stage "Great Revival," But No Easing Gas Prices*, NATIONAL GEOGRAPHIC DAILY NEWS (Feb. 10, 2012), http://news.nationalgeographic.com/news/energy/2012/02/120210-us-oil-production-increasing/

[33] Charles Dillon, *Oil Industry Tax Benefits Helping the Environment*, 7 U. BALT. J. ENVTL. L. 46, 47 (1999). *See Executive Summary, Oiling the Machine: Fossil Fuel Dollars Funneled into the US Political Process* (Oct. 27, 2011, 2:17 PM), http://archive.greenpeace.org/climate/kindustry/government/machine.html.

[34] *Id*. As of December 31, 2011, President Obama raised $139.5 million and Mitt Romney, the leading Republican candidate, raised $57,112 for the following presidential campaign. Evan Carmi, et. al. *The 2012 Money Race: Compare the Candidates*, N.Y. TIMES, (Dec. 12, 2012) http://elections.nytimes.com/2012/campaign-finance.

[35] *See supra* note 33 (suggesting that financial support for candidates increases industry support for favorable tax treatment, politically).

[36] *See generally* Peter Gardett, *Energy Voters as a Political Power*, THE HUFFINGTON POST, (Jan. 10, 2012, 2:25 PM) http://www.huffingtonpost.com/peter-gardett/energy-voters-as-a-politi_b_1192646.html (predicting that the Obama Administration's decision regarding the Keystone Pipelines carries great political clout).

[37] *See supra* note 33 (suggesting that financial support for candidates increases industry support for favorable tax treatment, politically).

Back to Table of Contents

III. OIL AND GAS TAX SUBSIDIES

This section provides a brief introduction to the ten most common oil and gas tax subsidies. Each tax subsidy consists of many elements and rules, but only the ones relevant to the arguments regarding its repeal are discussed.

A. *Percentage Depletion*

Percentage depletion is perhaps one of the "most . . . cited subsidies for oil and gas production."[38] It allows independent producers,[39] including individual investors, to deduct a flat percentage of the gross income produced by a well.[40] This is due to the naturally depleting nature of the oil or gas.[41]

The statute was meant to reflect the recovery of the capital investment in the well.[42] But the percentage depletion benefit continues on, even after the full investment in the well is recovered.[43] Additionally, the percentage depletion deduction increases as the commodity price increases because percentage deduction is calculated against the product's gross income, as opposed to its cost or production.[44] Therefore, the deductions can far exceed the project's basis or investment.[45]

Some limitations are placed on this generous subsidy: the statute allows a taxpayer to deduct fifteen percent of his or her gross income, but limits these deductions to one thousand

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[38] Bodgdanski, *supra* note 20, at 325. *See, e.g.*, Mann, *supra* note 5, at 387-86 (parenthetical); Patrick L. O'Daniel, *Muddy Waters in the Pool of Capital:* ZuHone *and the Abolition of the Doctrine*, 70 TEX. L. REV. 243, 251 n.49 (1991).
[39] Zarroll, *supra* note 7.
[40] I.R.C. §§ 611(a), 613(a)-(b), 613(A)(c)(6), 613(A)(c)(1) (2006).
[41] *Id*.
[42] I.R.C. § 611(a); Bodgdanski, *supra* note 20, at 325.
[43] I.R.C. § 611(a); Bodgdanski, *supra* note 20, at 325.
[44] I.R.C. § 611(a) (2006); *See* Starkman, *supra* note 21, at 186.
[45] I.R.C. § 611(a); Bodgdanski, *supra* note 20, at 325.

barrels of product per day and up to sixty-five percent of the taxpayer's net income.[46] Additionally, integrated companies[47] may not take advantage of percentage depletion.[48]They must utilize cost depletion, a method which allows deductions to be taken only when production costs occur, thereby limiting the deductions to costs and not gross income.[49]

The history of the creation of percentage depletion, dating back to 1926, emerged because of the high-risk and "exhaustible" nature of oil and gas extraction.[50] Originally, no distinctions were made between the lone "black-gold" seeker[51] and the Rockefeller-type investors.[52] Then, following the 1973 Arab Oil Embargo, in 1975, percentage depletion was reduced from 27.5% to fifteen percent.[53] Additionally, many limitations were placed on the subsidy, including distinguishing integrated companies from non-integrated ones.[54] Since then, this statute has not been revisited.[55] Past fears, to justify this statute, were rooted in expert predictions that oil supplies would last only ten more years.[56] In contrast, during modern times, Congress justified retaining the statute to "protect the prospector or wildcatter who risked

[46] Cecil, *supra* note 26, at 217.
[47] HOWARD WILLIAMS & CHARLES MEYERS, MANUAL OF OIL & GAS TERMS 367 (5th ed. 1981) (defining integrated oil and gas companies as companies which are "engaged in all phrases of the oil [and gas] industry, from exploration for oil [and gas] deposits to retail sale of oil [and gas] products").
[48] Cecil, *supra* note 26, at 217.
[49] Bodgdanski, *supra* note 20, at 325. As opposed to percentage depletion, which can continue to benefit the taxpayer even after all their costs have been deducted. I.R.C. § 611(a); Bodgdanski, *supra* note 19, at 325.
[50] OWEN L. ANDERSON, ET. AL, HEMINGWAY OIL AND GAS LAW AND TAXATION 635 (4th ed. 2004); Bodgdanski, *supra* note 20, at 325.
[51] *See* Starkman, *supra* note 21, at 186 (contrasting the different types of oil and gas drillers as "the adventurer and Standard Oil's John D. Rockefeller").
[52] *Id*.
[53] Starkman, *supra* note 21, at 186; JOHN S. LOWE, ET. AL, CASES AND MATERIALS ON OIL AND GAS LAW 332 (5th ed. 2008).
[54] LOWE, *supra* note 56, at 332.
[55] Starkman, *supra* note 21, at 186.
[56] *Id*.

drilling in unknown territory."[57] And correctly, many of the holes that were drilled as recently as fifty years ago, were dry.[58]

B. *Intangible Drilling Costs (IDCs)*

Intangible drilling costs are any costs generally related to drilling a well that cannot recover a salvage value.[59] Examples of such expenditures are costs related to labor, fuel, power, materials, supplies, tool rentals and repairs associated with drilling, and equipping productive wells.[60] The deductions may also be applied towards the intangible costs of drilling exploratory wells, if those wells also might produce oil or gas.[61]

Generally, section 263 of the Tax Code allows integrated oil companies to immediately deduct seventy percent of their IDCs, and independent oil producers[62] can deduct one hundred percent of their IDCs.[63] The remaining thirty percent of the IDCs that integrated oil companies cannot immediately deduct are amortized over a sixty-month period or more.[64]In addition, taxpayers can choose to bypass these deductions and amortize all their IDCs instead.[65] However, this advantage is not utilized often, as most oil and gas companies will choose to deduct their

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[57] *Id*.
[58] *Id*. It is interesting to note that percentage depletion began as a subsidy specifically for oil and gas production due to its depletable nature, yet this subsidy was not offered to other depletable minerals, such as coal. *Id*. at 193.
[59] ANDERSON, ET. AL, *supra* note 50, at 546. Salvage value is "the amount expected to be obtained when a fixed asset is disposed of at the end of its useful life. BLACK'S LAW DICTIONARY 743 (2nd Pocket ed. 2001).
[60] STEPHEN L. MCDONALD, FEDERAL TAX TREATMENT OF INCOME FROM OIL AND GAS 10 (1963); I.R.C. § 1.612-4(c)(2) (West 2006).
[61] I.R.C. § 1.612(4)(a), (c)(1) (2006).
[62] *Id*. at 356 (defining independent oil companies as companies that are "(1) [a] purely domestic organization not dependent on foreign oil; (2) A company or individual whose actual management and financial source are substantially the same; (3) A person who produces oil and gas and is not engaged in transportation, refining or marketing of such products").
[63] I.R.C. § 263(c) (2006); I.R.C. § 291(b)(1) (2006); Treas. Reg. § 1.612-4 (2010).
[64] I.R.C. § 291(b)(1)-(2) (2006); Rev. Rul. 93-26, 1993-1 C.B. 50, 51.
[65] *See* I.R.C §§ 55(b)(2), 59(e) (2006).

IDCs expenses.[66] Coincidentally, deducting costs means that the gain on a sale or exchange of the well property will be taxed as ordinary income, not capital gain.[67]

The primary purposes for the intangible drilling costs tax deduction, as explained by Congress in 1954, was because it was "in the public interest"[68] and affirmed the Treasury's percentage depletion provision.[69] The historical reasoning behind the decision to allow IDC deductions is ambiguous.[70] Thus far, not much has changed, as the current motivation behind IDC deduction continuation is still "completely rooted in the public policy of an industry incentive."[71]

C. *Domestic Manufacturing Activity*

The manufacturing tax deduction allows a reduction in the income tax rate "equal to a percentage of the lesser of taxable income or income from domestic 'production' activities."[72] Manufacturing activity includes activity such as manufacturing, production, and extraction, including architecture, engineering, movies, and construction.[73] Activities involving "selling" a product do not qualify for the deduction.[74] And, unlike other domestic manufacturing industries

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[66] Cecil, *supra* note 24, at 212, 219.
[67] This is so taxpayers do not receive a double benefit by receiving a more favorable tax rate (usually a capital gains rate) and deduction benefits. I.R.C. § 1254 (2006). Generally, capital gain is taxed at a lesser (more advantageous) rate than ordinary income. MCDONALD, *supra* note 60, at 540.
[68] ANDERSON, ET. AL, *supra* note 50, at 545; H.R. Con. Res. 50, 79th Cong., 1st Sess., 59 Stat. 844 (1945).
[69] Starkman, *supra* note 21, at 189 (2011). *See* supra Part III.A (explaining the percentage depletion tax subsidy for oil and gas wells).
[70] ANDERSON, ET. AL, *supra* note 50, at 545–46.
[71] *Id*. This purpose is similar to Congress' "public interest" purpose behind the IDC deduction in 1954. ANDERSON, ET. AL, *supra* note 50, at 545; H.R. Con. Res. 50, 79th Cong., 1st Sess., 59 Stat. 844 (1945).
[72] Bodgdanski, *supra* note 20, at 327.
[73] GRAETZ & SCHENK, *supra* note 3, at 254.
[74] *Id*. What qualifies as "selling" activities may be confusing. For example, roasting coffee beans sometimes qualifies as manufacturing and sometimes does not. *Id*.

Back to Table of Contents

whose tax income rates are essentially reduced by nine percent, oil and gas tax rates are reduced by six percent.[75]

Some restrictions to the domestic manufacturing subsidy are that deductions are limited to fifty percent of the domestic wages paid by the taxpayer and allocable to the income that makes up the base of the deduction.[76] Even so, the deduction is a great advantage to oil and gas companies involved in the activities of extraction and production.[77] In fact, the combination of many of these deductions might even lead to a negative income tax.[78]

Originally, the manufacturing tax deduction was created to encourage production and manufacturing activities that was domestically "manufactured, produced, grown or *extracted*."[79] Interestingly, oil and gas activities were only recently categorized as a manufacturing industry in the 2004 American Jobs Creation Act.[80] And, under that Act, oil and gas companies were able to incorporate phased in reductions of extraction costs over the next several years.[81]

D. *Geological and Geophysical Expenses*

Geological[82] and geophysical[83] research expensed by non-integrated companies is amortized over a two-year period.[84] Integrated companies grossing over one billion dollars

[75] I.R.C. § 199(a)(1); I.R.C. § 199(d)(9) (Supp. II 2009).
[76] I.R.C. § 199(d) (2006).
[77] I.R.C. §§ 613A(d)(2)–(4) (2006); *see, e.g.*, Calvin H. Johnson, *Accurate and Honest Tax Accounting for Oil and Gas*, 125 TAX NOTES 573, 577 (2009) (displaying examples of oil and gas companies that may pay combine some of these subsidies to result in a negative tax).
[78] *Id*. Negative income tax is "a system of income subsidy through which persons having less than a certain annual income receive money from the government rather than pay taxes to it." *Negative Income Tax Definition*, DICTIONARY.COM, http://dictionary.reference.com/browse/negative+income+tax (last visited Feb. 13, 2012).
[79] I.R.C § 199(d) (2006); GRAETZ & SCHENK, *supra* note 3, at 254.
[80] American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 102, 118 Stat. 1418, 1525-29.
[81] Robert Pirog, CONG. RESEARCH SERV., R40715, *Oil Industry Tax Issues and Deficient Issues*, 4, 6 (2009) [Hereafter "Pirog, R40715"]; Cecil, *supra* note 24, at 219.
[82] *See* ANDERSON, ET. AL, *supra* note 50, at 534 ("Geological costs are those exploratory costs that relate to the study of the geology of the surface and subsurface. They include a study of

Back to Table of Contents

amortize those costs over seven years.[85] This provision is especially helpful to taxpayers utilizing percentage depletion because the percentage depletion subsidy is based on a percentage of the taxpayer's overall revenue.[86] If these costs could not be amortized over two years and were included in the basis of the well, many of the advantages of percentage depletion would be completely lost.[87]

Before 1941, geological and geophysical expenses were analogous to other research expenses and deducted as an ordinary and necessary business expense, deductible in the year paid or incurred.[88] Then in 1946, the tax court in *Louisiana Land & Exploration v. Commissioner* decided that geo-research activities do not distinguish themselves from activities such as "plating, mapping, and subdividing [] a tract of land."[89] Therefore, geological and geophysical expenses should be similarly capitalized.[90]

Note that section 615 and section 617 of the Tax Code refer to the overall treatment of mineral exploration but do not specifically address oil and gas exploration.[91] In fact, no tax provision addresses the treatment of geophysical and geological costs related to oil and gas exploration.[92]

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surface outcropping and anomalies, core samples from slim holes drilled at shallow depths, core samples from other wells in the vicinity, and interpolation of the information with other such information from the vicinity."). *La. Land & Explor'n v. Comm'r*, 7 T.C. 507, 510 (1946).

[83] *See* ANDERSON, ET. AL, *supra* note 50, at 534 ("Geophysical costs result from seismic surveys, gravity and magnetic surveys, electrical resistance, and intensity studies."); *see also id.* at 534 (listing legally defined geophysical activities).

[84] I.R.C. § 167(h)(5) (2010).

[85] *Id*.

[86] Bodgdanski, *supra* note 20, at 326; *see infra* Part V.B (describing the advantages of the percentage depletion tax subsidy).

[87] Bodgdanski, *supra* note 20, at 326.

[88] Frank Burke, Jr. *Current Expensing of Geological and Geophysical Costs: A Need for Legislative Clarification*, 34 OKLA. L. REV. 778, 780 (1981).

[89] *Louisiana Land & Exploration v. Comm'r*, 7 T.C. 507, 510 (1946).

[90] *Id*. at 516.

[91] I.R.C. §§ 615, 617 (2006); ANDERSON, ET. AL, *supra* note 50, at 534.

[92] I.R.C. §§ 615, 617 ; ANDERSON, ET. AL, *supra* note 50, at 534.

Back to Table of Contents

E. *Passive Loss Exceptions For Working Interests*

Normally, investors who do not materially and actively manage their investments are considered "passive" investors.[93] Passive investors are only entitled to deduct passive losses from the corresponding passive gains.[94] This rule was enacted in 1986[95] to prevent beneficial loss deductions from primarily tax shelter-type investments.[96]

However, taxpayers who might otherwise be considered passive investors can bypass those rules if they have a "working interest" in oil and gas wells.[97] A working interest is a "burden in the cost of development and operation of the property."[98] More specifically, one qualifies as a working interest owner if they typically: (1) are kept informed of operations; (2) have a proportionate share in voting rights regarding the property; (3) have responsibility for signing authorizations for expenditure; (4) have the option to continue operations if the current operator ceases; (5) are subject to proportionate tort liability; and (6) bear at least some responsibility for future costs related to the property.[99] If these requirements are met, persons who do not actively manage their property are still eligible to participate in the tax shelter.[100]

F. Deductions for Tertiary Injections

Tertiary injections are regularly utilized to encourage output from older wells.[101] Usually, expenses incurred towards profit-creating activity, such as tertiary injections, are capitalized.[102]

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[93] I.R.C. § 469 (2006); GRAETZ & SCHENK, *supra* note 3, at 415.
[94] I.R.C. § 469 (2006); GRAETZ & SCHENK, *supra* note 3, at 415.
[95] ANDERSON, ET. AL, *supra* note 50, at 534.
[96] GRAETZ & SCHENK, *supra* note 3, at 414.
[97] I.R.C. § 469(c)(3) (2006); Bodgdanski, *supra* note 20, at 327.
[98] ANDERSON, ET. AL, *supra* note 50, at 534.
[99] S. REP. NO. 99-313, at 744 (1986).
[100] Bodgdanski, *supra* note 20, at 327.
[101] *See* Pirog R40715, *supra* note 76, at 4 (parenthetical).
[102] GRAETZ & SCHENK, *supra* note 3, at 311.

Back to Table of Contents

However, § 193 allows tertiary injection expenses to be deducted.[103] This is permitted even if the taxpayer did not elect to deduct intangible drilling costs.[104] One limitation to this deduction involves the use of recoverable hydrocarbons.[105] If more than an "insignificant" amount of hydrocarbons is used, one can only deduct the lower of the cost of injecting the hydrocarbons, or the market value of the hydrocarbon.[106]

Additionally, a tax credit is available for injection expenses and for production from marginal wells.[107] However, these benefits do not come into play unless oil and gas prices are far below current prices.[108] Therefore these benefits have not been utilized for quite some time.[109]

G. *LIFO Inventory Accounting*

Last In First Out (LIFO) inventory accounting allows taxpayers to record their most recently acquired products as the first ones sold.[110] This is in contrast to the First In First Out (FIFO) accounting method, which is internationally utilized and has generally replaced LIFO.[111] While other industries are commonly required to use FIFO,[112] some oil and gas companies are permitted to utilize LIFO.[113] In that case, as oil and gas prices rise, LIFO

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103 *See* JOINT COMM. ON TAXATION, 111TH CONG., OIL AND GAS TAX PROVISIONS: A CONSIDERATION OF THE PRESIDENT'S FISCAL YEAR 2010 BUDGET PROPOSAL 21-22 (2009) (containing a chart of the major legislation regarding oil and gas tax since 1969).
104 I.R.C. § 193(a) (2006); Bodgdanski, *supra* note 20, at 326; *see supra* Part II.B (noting that one can elect to utilize IDCs or not).
105 I.R.C. §§ 43(a), (c)(1)(C) (West 2006).
106 I.R.C. §§ 43(a), (c)(1)(C) (2006).
107 I.R.C. §§ 43(b), 451(b)(2) (2006).
108 I.R.C §§ 451, 469(c)(3) (2006).
109 Starkman, *supra* note 21, at 189.
110 I.R.C. § 472 (2006); Bodgdanski, *supra* note 19, at 325.
111 Sharda Sharma, *The Impact of the Adoption of International Financial Reporting Standards on the Legal Profession*, 10 HOUS. BUS. & TAX L.J. 139, 158 (2010); *see also* Lee A. Sheppard, *Cash on the Barrelhead: BP and Taxes*, 128 TAX NOTES 571, 576 (2010).
112 Sharma, *supra* note 91, at PIN; Sheppard, *supra* note 91, at PIN.
113 I.R.C. § 472 (2006); Bodgdanski, *supra* note 19, at 325.

Back to Table of Contents

inventory accounting allows oil and gas companies to substantially reduce their taxable income.[114]

H. *Pool of Capital Doctrine and Carried Interests*

Drilling companies may choose to reward landowners, drillers, and suppliers with economic interests in the future profits of the operations as opposed to payment for services.[115] Transfers of this sort are not treated as taxable income to either side of the transaction due to the pool of capital doctrine.[116] Neither is this transaction taxable under the general concept of partnership interest (otherwise known as "carried interests").[117] This type of benefit is considered a tax subsidy because in-kind exchanges should be recognized on income statements.[118] Yet, in this case, neither party recognizes this exchange on their income statements.[119]

I. *Credit for Enhanced Oil Recovery Costs*

This credit allows taxpayers to claim a tax credit of fifteen percent on certain costs.[120] Some of these costs include intangible drilling and development costs, tertiary injection expenses, costs from certain Alaskan natural gas facilities, and amounts paid for depreciable tangible property.[121] This subsidy is currently not utilized because it is phased out when barrels are priced above $41.[122]

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114 Bodgdanski, *supra* note 20, at 325.
115 Johnson, *supra* note 77, at 574.
116 *See, e.g.*, Rev. Rul. 77-176, 1977-1 C.B. 77, 78.
117 Rev. Proc. 2001-43, 2001-2 C.B. 191, 191; I.R.S. Notice 2005-43, 2005-1 C.B. 1221, 1224.
118 GRAETZ & SCHENK, *supra* note 3, at 103.
119 Bodgdanski, *supra* note 20, at 328.
120 I.R.C. § 43 (2006).
121 *Id.*
122 Johnson, *supra* note 77, at 583.

J. *Marginal Well Tax Credit*

Added to the Code in 1994, this tax credit provides a minimal credit for oil and gas produced[123]. This provision was created to provide a "safety net for marginal wells during period of low prices."[124] However, this benefit is only available to producers with a daily production of twenty-five barrels or less.[125]

IV. GENERAL ECONOMIC AND ENVIRONMENT CONSIDERATIONS IN REPEALING SUBSIDIES

One of the criticisms towards tax subsidies is that they encourage inefficient consumption.[126] This is because subsidies distort the true economical value of investment, exploration, and consumption by misrepresenting its actual worth.[127] In other words, taxpayers could make poor consumption choices because the tax system has caused a cost to become "overvalued."[128] This is because tax subsidies can "lead to an over allocation of resources to the tax-favored industries and an under allocation of resources to other industries."[129] In some

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[123] I.R.C. §451(b)(1) (West 2006).
[124] OIL AND GAS TAX PROVISIONS: A CONSIDERATION OF THE PRESIDENT'S FY 2010 BUDGE PROPOSAL: HEARING BEFORE THE SUBCOMM. ON ENERGY, NATURAL RESOURCES AND INFRASTRUCTURE OF THE S. COMM. ON FINANCE, 111TH CONG. 2, 7 (2009) (statement of Alan B. Krueger, Assistant Secretary for Economic Policy and Chief Economist, United States Department of the Treasury).
[125] I.R.C. §613(A)(c)(6) (West 2006).
[126] *See* Janet Sterns, *Low-Income Housing Tax Credit: A Poor Solution to the Housing Crisis*, 6 YALE L. & POL'Y REV. 203, 205 (1988) (suggesting that tax credits for low-income housing leads to inefficient policy); JOSHUA D. ROSENBERG & DOMINIC L. DAHER, THE LAW OF FEDERAL INCOME TAXATION PRINCIPLES AND POLICIES 18 (6th ed. 2008) (discussing that one of the main issues of tax is fairness and equality in it's general application).
[127] Johnson, *supra* note 77, at 577.
[128] *Id*.
[129] Letter from Kim Wallace, Assistant Secretary for Legislative Affairs, to Honorable Lynn Jenkins, U.S. House of Representatives (Apr. 21, 2010) (on file with West Law online database) [hereafter "Letter from Kim Wallace"].

instances, tax subsidies serve as a social or moral cause, such as subsidies towards housing[130] and healthcare[131]. Those are often seen as an integral part of supporting humanity (one needs shelter and minimal healthcare to survive) and therefore often justified.[132] In fact, oil and gas subsidies do provide some forms of livelihood, including nine million jobs, mineral resources, and industry.[133] However, it is most likely that without tax subsidies, the economic benefits derived from oil and gas will continue.[134] Oil and gas is already viewed as an extremely affluent industry.[135] For example, the three largest oil and gas companies—Shell, Chevron, and Conoco Phillips—made combined profits of over $60 billion in one year.[136] This forces a reevaluation of how much industry support is needed, or should be warranted from tax subsidies.[137]

Originally, many of the tax subsidies for oil and gas industries were constructed under the rationale that the industry needed protection during times of low prices to maintain national energy security.[138] This rationale no longer stands, as oil and gas prices have risen to the point where price alone drives industry growth.[139] In fact, talk of repeals has been ongoing since the

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[130] JOINT COMM. ON TAXATION, *supra* note 2, at 9.
[131] *Id*.
[132] *See* GRAETZ, *supra* note 3, at 53-54 (explaining that social spending types of subsidies, such as for housing and healthcare, are meant to induce a certain type of behavior that is unrelated to business spending, but "geared towards income support for retirement").
[133] Zarroll, *supra* note 7.
[134] *See* Johnson, *supra* note 77, at 574 (stating that the "price of oil provides a sufficient free-market incentive to explore for and extract oil and gas . . . in every case").
[135] *See supra* note 27 (displaying ExxonMobil's profits at $30.5 billion, Chevron's profits at $19 billion, and ConocoPhillip's profits at $11.4 billion).
[136] Id. Note that other "bigger" U.S. publicly listed companies, such as JPMorgan Chase and General Electric, only make profits of $17.4 billion and $11.6 billion, respectively, which is much less than Shell and Chevron's profits. *Id*.
[137] Zarroll, *supra* note 7.
[138] *See* OIL AND GAS TAX PROVISIONS, *supra* note 124, at 2 (statement of Stephen Brown, Nonresident Fellow, Resources for the Future) (parenthetical).
[139] Cecil, *supra* note 24, at 221.

1940s and is not a novel consideration by the Obama Administration.[140] But currently, motivation for future federal budget proposals is fueled by an incentive to build up the country's alternative energy industry while eliminating dependence on foreign oil.[141]

As stated, one of the reasons for reexamining these oil and gas tax subsidies is to incentivize investment in alternative energy investment.[142] This has been reiterated multiple times as talks continue regarding the repeal of oil and gas tax subsidies.[143] One of the major reasons why there is so much attention on alternative energy is because it serves to lessen global warming, decrease dependence on foreign oil, and lower energy costs.[144] But, because of the

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[140] *Id.* at 215; *see* JOINT COMM. ON TAXATION, 111TH(((superscripted? check globally))) CONG., OIL AND GAS TAX PROVISIONS: A CONSIDERATION OF THE PRESIDENT'S FISCAL YEAR 2010 BUDGET PROPOSAL, at 21-22 (containing a chart of the major legislation regarding oil and gas tax since 1969; *see also* J.P. Jackson, *Federal Income Tax Percentage Depletion of Oil and Gas Wells–Another View,* 6 Tex. L. Rev. 798, 799 (1943) (describing the effort to repeal the percentage depletion oil and gas subsidy in 1942 in front of the Ways and Means Committee of the House of Representatives).

[141] STAFF OF H. COMM. ON THE BUDGET, 111TH CONG., SUMMARY OF THE PRESIDENT'S FISCAL YEAR 2010 BUDGET, at 2.

[142] *Id.*; *see* Robert Pirog, CONG. RESEARCH SERV., R41139, Oil Industry Tax Issues in the Fiscal Year, 1 (2011) [hereafter, "Pirog, R41139"](((make sure your formatting is consistent throughout))) (recalling Obama's 2009 Earth Day speech which emphasizes the importance in developing technology for alternative energy to lower the country's dependence on foreign oil).

[143] *Id. See, e.g.*, Christoper Riti, *Three Sheets to the Wind: The Renewable Energy Production Tax Credit, Congressional Political Posturing, and an Unstable Energy Policy*, 27 PACE ENVTL. L. REV. 783, 809 (2010) ("Many of the conventional energy industries had had the decades-long endorsement and financial backing of the federal government . . . with these considerations in mind, there is no escaping the fact that to adequately fund the PTC, Congress must repeal part of all of those subsidies currently available that qualify, in effect, as handouts to matured industries."); *see also* Letter from Kim Wallace, *supra* note 129 ("The current set of tax subsidies for oil and gas production also work against the goals of reducing the negative externalities associated with oil and gas production and transitioning to cleaner energy sources.").

[144] *See generally Benefits of Renewable Energy Use*, UNION OF CONCERNED SCIENTISTS: CITIZENS AND SCIENTISTS FOR ENVIRONMENTAL SOLUTIONS, (Jan. 12, 2012, 8:26 PM), http://www.ucsusa.org/clean_energy/technology_and_impacts/impacts/public-benefits-of-renewable.html. Many of the benefits of alternative energy meet the goals of that oil and gas tax subsidies were designed to meet. *See* supra Part II, note 141 and accompanying text, note 145 and accompanying text (juxtaposing Congress's goals to attain energy independence, security,

Back to Table of Contents

capital-intensive nature and delayed returns associated with clean energy projects, many are reluctant to invest.[145] The industry may even be in a "stall" due to the lack of financial support.[146]

Oil and gas tax subsidies also exacerbate this issue in two additional ways: first, the investment in oil and gas is over encouraged, and second, oil and gas consumption prices are understated.[147] In addition, creating more incentive to invest in oil and gas than alternative energy basically encourages pollution.[148] This path will ultimately lead to society sharing a burden of billions of dollars, as taxpayers and government must eventually address the pollution caused by the fossil fuel era.[149] This is especially true, as that fossil fuel era is projected to continue into the next sixty years.[150] So while investment in alternative energy is already severely handicapped by the long-term return and high-risk nature of the investment,[151] current oil and gas tax subsidies cause even greater disparity between the two choices.[152]

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and low prices, against those of Congress' goals regarding the development of alternative energy).

145 Riti, *supra* note 112, at 786.

146 *See* Denis Hayes, *Solar and Wind Power Held Hostage—Again*, YALE ENV'T 360 (Oct. 29, 2011, 4:56PM), http://e360.yale.edu/feature/solar_and_wind_power_held_hostage_again/2060/ (concluding there is a "stall" in the alternative energy industry perpetuated by a lack of investment).

147 Riti, *supra* note 112, at 787; *see* Letter from Kim Wallace, *supra* note 129 (stating that oil and gas prices do not convey the cost of environmental harm from greenhouse gases through its consumption and that spending choices are distorted due to the favoring affect of subsidies).

148 Douglas Koplow & Aaron Martin, *Fueling Global Warming: Federal Subsidies to Oil in the United States* (Oct. 27, 2011, 2:41 PM), http://archive.greenpeace.org/climate/oil/fdsuboil.pdf.

149 *Id*.

150 *See* Clifford Krauss, *New Technologies Redraw the World's Energy Picture*, N.Y. TIMES, (Oct. 25, 2011), http://www.nytimes.com/2011/10/26/business/energy-environment/new-technologies-redraw-the-worlds-energy-picture.html ("[T]he fossil fuel age will be extended for decades . . . unconventional oil and gas are at the beginning of a technology cycle that can last 60 years.").

151 Riti, *supra* note 112, at 786.

152 *See* Letter from Kim Wallace, *supra* note 129 (reiterating that spending choices are distorted due to the favoring affect of oil and gas subsidies).

It is also important to point out that greater investment in alternative energy means less dependence on foreign oil, a positive consequence of repealing these tax subsidies.[153] But, just as easily, these repeals could result in negative effects.[154] For example, investors could choose to place their money in other "tried and true" fossil fuels, or anywhere else of their choosing.[155] After all, repealing oil and gas tax subsidies does not automatically make investing in alternative energy a more attractive option.[156] To resolve this issue, the federal government could place the revenue from the additional oil and gas taxes directly into supporting alternative energy.[157] On the other hand, because the alterative energy industry already has its own tax incentives for investment,[158] the repeal may sufficiently serve its purpose by merely balancing the energy "playing field."[159]

The main reason for repealing tax subsidies is to create revenue for the government.[160] All negative effects from the repeal should be weighed against the positive effects of additional

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[153] *See Benefits of Renewable Energy Use*, *supra* note 144 (dependence on foreign oil leaves America vulnerable to fuel price shocks or shortages).

[154] *See* Pirog, R41139, *supra* note 142, at 6 (exploring the negative effect of oil and gas tax subsidy repeals, as "tax changes . . . [could increase] the nation's foreign oil dependence").

[155] *See* Bodgdanski, *supra* note 20, at 333 ("If capital is pulled out of oil and gas, it may be redirected to industries that are no less harmful to the environment.").

[156] *See id*. ("[I]t is not clear that eliminating them would stimulate interest in alternative energy sources, any more than it would stimulate interest in completely different types of investments.").

[157] Bodgdanski, *supra* note 20, at 336.

[158] *See* Mann, *supra* note 5, at 386 ("[R]enewable energy enjoys federal tax benefits primarily through the production tax credit (PTC) and the investment tax credit (ITC)."); I.R.C. § 45 (2009) (ITC provides a tax credit of 30 percent of the project cost for "energy property"); *id.* at § 48 (PTC reduces tax liability over a ten year period after the project beings producing electricity based on the amount of electricity produced, rather than on the cost of the property).

[159] *See* Riti, *supra* note 112, at 786 (arguing that in order to sustain alternative energy tax credits, oil and gas tax subsidies must be repealed).

[160] *See* Cecil, *supra* note 24, at 211 ("The effect of the repeal of these tax incentives is estimated to be almost $36 billion in tax revenue over the next ten years).

revenue for the government.[161] The amount of revenue is questionable – although the tax subsidies create tax expenditures of $32.3 billion over the past four years,[162] the revenue created by a repeal of these subsidies will not generate exactly $32.3 billion.[163] This is due to possible changes in investment behavior as a reaction to the tax repeal.[164] In addition, the government will share in some of the potential profit loss that oil and gas companies may experience upon the repeal.[165] Therefore, the projected revenue income is uncertain, but some predict these repeals will result in an additional $18.2 billion in revenue over the next four years,[166] or $36 billion in revenue over the next ten years.[167]

There are arguments that $32.3 billion is too insignificant to justify repealing numerous oil and gas subsidies, as the benefit is basically the equivalent of the brief but effective "cash for clunkers" automobile subsidy program.[168] And, these tax expenditures amount to less than one-

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[161] *Id.*
[162] *See supra* Part I (nothing that amount of tax expenditures created through oil and gas subsidies).
[163] *See infra* note 167 (explaining why tax expenditure calculations do not equal the amount of federal revenue gained upon the repeal of that tax subsidy).
[164] *See* JOINT COMM. ON TAXATION, *supra* note 2, at 5 (explaining that tax expenditure calculations cannot be compared directly with projected revenues – the two are not the same because "actual repeal would have behavioral consequences that would affect post-repeal revenue collections").
[165] *See* Livingston, *supra* note 1, at 183 (suggesting that according to the Domer-Musgrave model, risk-taking can be offset by federal income tax loss deductions, instead of immediate deductions); James Tobin, *Liquidity Preference as Behavior Toward Risk*, 25 REV. ECON. STUD. 65, 70 (1958) (applying an expected utility, indifference curve analysis proof to demonstrate that taxing a full loss offset can result in increased social or public risk).
[166] Pirog, R41139, *supra* note 142, at Summary; Bodgdanski, *supra* note 20, at 332.
[167] *See* Office of Mgmt. & Budget, Exec. Office of the President, Mid-Session Review, in Budge of the United States Government, Fiscal Year 2010, at 44-45 (2009), available at http://www.gpoaccess.gov/usbudget/fy10/pdf/10msr.pdf (calculating that $35.97 billion will be eliminated from the deficit through the elimination of oil and gas company tax preferences).
[168] Bodgdanski, *supra* note 20, at 332.

Back to Table of Contents

tenth of the expenditures generated by housing and health subsidies.[169] While the tax expenditures for housing and health dwarf the tax expenditures for oil and gas, the policies and objectives behind those tax expenditures are more grounded in the social well-being of every American (whether or not these goals are actually met).[170] But, one should compare housing and healthcare subsidies to oil and gas subsidies, which affects primarily one industry and, at least nowadays, seems to make the rich even richer.[171] Eventually, all tax expenditures should be reexamined for their effectiveness and purpose.[172] Oil and gas subsidies, regardless of the marginal amount amongst other tax expenditures, can be easily re-examined due to the limited number of beneficial tax provisions.[173] And, a repeal of these provisions will most likely not result in dire effects and consequences due to the forecasted, continuing, high oil and gas prices.[174]

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[169] *See* GRAETZ, *supra* note 3, at 44 (displaying housing tax expenditures total $430.2 billion and health tax expenditures total $628.5 billion).

[170] *See infra* Part I (explaining the purposes behind health and housing subsidies). Note that the health tax expenditure is also currently scrutinized for its effectiveness and is subject to change if the Obama Administration's healthcare reform is passed. *See generally* Kate Pickert, *Details of Obama's Health Care Plan*, Time (Jan. 13, 9:19PM), http://swampland.time.com/2010/02/22/details-of-obamas-health-care-plan/ (mandating a raised threshold for which plans may be taxed and federal regulation of insurance costs, as an example of a few changes to come).

[171] 171 *See supra* note 27 and accompanying text (displaying ExxonMobil's profits at $30.5 billion, Chevron's profits at $19 billion, and ConocoPhillip's profits at $11.4 billion). *See* Johnson, *supra* note 77, at 574 (inferring that certain subsidies, such as the manufacturing subsidy, are basically "handouts" to oil and gas companies).

[172] *See generally* Starkman *supra* note 21 (arguing that tax subsidies in general, even beyond oil and gas subsidies, should be re-examined and repealed if unnecessary or do not meet their purpose).

[173] *See supra* Part II (listing the ten most popular oil and gas tax subsidies to be repealed).

[174] *See supra* Part III (arguing that demand for oil and gas in itself will sustain the industry past the reap of oil and gas tax subsidies).

The additional revenue from a repeal could help alternative energy overcome their investment hurdles[175] if at least a portion of the revenue is set-aside for that industry.[176] Or, budget proposals to simultaneously increase taxes for oil and gas companies while providing additional subsidies for alternative energy research could subtly sway investors in the direction of alternative energy.[177]

One additional argument against the repeal of preferential oil and gas tax subsidies is that if oil and gas prices rise, Americans will look to other nations to supply their needs.[178] Thus, the repeal of oil and gas taxes will not decrease oil dependency, but actually increase it.[179] However, as the supply of oil and gas continues to grow in Canada and America,[180] and access to the Arctic supply opens up to America,[181] the picture of global "oil dependency" is changing.[182] Some predict that the global oil and gas trade will evolve from a predominately east-west trade to a north-south trade, thereby changing our negative impressions of what foreign oil dependency really means.[183] This is because dependency on oil from Canada is very different from

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[175] *See* Denis Hayes, *Solar and Wind Power Held Hostage—Again*, YALE ENV'T 360 (Oct. 29, 2011, 4:56PM), http://e360.yale.edu/feature/solar_and_wind_power_held_hostage_again/2060/ (illustrating that there is a "stall" in the growth of the alternative energy industry due to a lack of investment).
[176] *See* Bodgdanski, *supra* note 20, at 333 ("the proposed . . . legislation that would have repealed many oil and gas tax subsidies would have used the resulting revenue to establish an alternative energy reserve fund").
[177] *See* Pirog R41139, *supra* note 142, at 6 (forecasting budget proposals to increase oil and gas taxes while increasing subsidies for alternative energy).
[178] *See* Bodgdanski, *supra* note 20, at 333 ("The markets for oil and gas are global, and production that is subject to U.S. taxation makes up but a small percentage of overall supply.")
[179] *Id*.
[180] *See infra* Part IV.D (explaining that the recent increase in supply of oil and gas is largely due to the contributions made by geological and geophysical research).
[181] Krauss, *supra* note 150.
[182] *Id*.
[183] *See id*. (predicting that as the oil supply grows, especially in Canada, the Middle East will trades with China and Canada will trade with the United States.").

Back to Table of Contents

dependency on oil in the Middle East.[184] To illustrate, trading between American and Canada is much more politically stable, economically symbiotic, and less costly.[185] Therefore, older arguments against foreign oil dependency, focusing primarily on the Middle East, no longer hold as much merit today because of the increasing global supply of oil and gas.[186]

IV. THE REPEAL OF SPECIFIC SUBSIDIES

A. Percentage Depletion

The purpose behind percentage depletion is obsolete when it comes to oil and gas because of the "black gold" nature of this natural resource.[187] Regardless of the "depletability" of the resource, oil and gas will still be heavily sought wherever it is found.[188] Therefore, subsidies such as percentage depletion are not required to encourage the industry to extract the resource.[189] The price, demand, and profitability of oil and gas alone, are motivation enough.[190]

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[184] *See id.* (noting that Canada is politically stable).
[185] *See id*. (inferring that trading with Canada is much more stable and dependable than trading with the Middle East). Due to the political stability, increased supply, and lower transport costs. *See id*.
[186] *See generally* Krauss, *supra* note 150 ("[t]he fossil fuel age will be extended for decades").
[187] *See* DANIEL YERGIN, THE PRIZE, 536 (2008)(recanting a well-known oil and gas poem that ends in "oil that is, black gold, Texas tea").
[188] *See* DANIEL YERGIN, The Quest, 161 (2011) ("Even though total world petroleum consumption grew by 25 percent between 1980 and 2000 . . . the demand shock–that hit the world oil market in 2004 . . . propelled consumption upward").
[189] *See* Part IV.A (arguing that percentage depletion is not required, generally because the demand of the product will sustain it's profitability, even beyond the repeal of percentage depletion)
[190] *See* Pirog R41139, *supra* note 142, at 6 (arguing that taxpayers will continue to invest in oil and gas beyond the repeal of percentage depletion because American allows personal ownership of oil and gas, unlike other countries in which the nation government owns the resources).

Back to Table of Contents

Another reason that percentage depletion is obsolete is that the current exhaustibility of oil and gas is questionable.[191] For example, recent technological advances have facilitated discovery of new areas of oil and the ability to extract that oil.[192] From the oil sands of Canada to the deep-water reserves in India, and back to the shale rocks of America, what was once thought to be a finite and declining resource is now "at the beginning of a technological cycle . . . in their infancy."[193] And, while some may consider the "depletability" factor as one measured by the amount of oil in each individual oil reserve, historical policy arguments for the subsidy suggested the lawmakers supported this subsidy by questioning the exhaustibility of oil and gas as a whole.[194] Therefore the depletability argument could possible be misapplied.[195] Additionally, percentage depletion is an anomaly amongst tax provisions because it allows deductions past the amount of costs invested.[196]

Arguments against the repeal of percentage depletion state that because percentage depletion only applies to non-integrated companies,[197] the repeal of this tax will destroy the "little man."[198] However, this argument is untenable because the repeal of percentage depletion from integrated companies, while affecting company profits, did not affect oil production

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191 *See generally* Krauss, *supra* note 150 (arguing that new oil sources, such as oil sands in Canada, and other technological advances puts into serious question the exhaustibility of oil and gas).
192 *Id.*
193 *Id.*
194 *See* Starkman *supra* note 21, at 186 ("It all began with World War I. Dissatisfied with what is perceived to be an onerous tax burden, the oil industry introduced geological experts who warned that our limited supply of oil would be exhausted in 10 years. Congress responded with generous depletion provision.").
195 *Id.*
196 Starkman, *supra* note 21, at 190.
197 *See infra* Part IV.A (noting that the advantages of the percentage depletion subsidy only apply to non-integrated companies).
198 Cecil, *supra* note 24, at 217.

Back to Table of Contents

volume.[199] That is a strong argument that the repeal of percentage depletion, arguably one of the most advantageous tax subsidies, does not affect investment.[200]

Although the repeal of percentage depletion for integrated companies resulted in minimal consequences, non-integrated companies are different in numerous ways.[201] One cannot fail to point out that non-integrated companies are generally more risk-averse.[202] There are arguments for both sides on whether non-integrated companies may survive the repeal of percentage depletion.[203] But, although severe, one should consider that if a company cannot survive without generous subsidies, then it is not an ideal candidate to continue in that industry.[204] Americans believe that the backbone of America is small businesses because it encourages diversification and creativity.[205] But that might not apply in the oil and gas industry because oil and gas requires significant capital investment and large risks.[206] Additionally, it not longer allows for as much entrepreneurial spirit as it did in the days of the wildcatters.[207]

Ultimately, the repeal of percentage depletion will expose naked profits to investors, allowing them to make accurate choices and not choices based on tax handouts set by the

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[199] *Id.*; Pirog R41139, *supra* note 142, at 6.
[200] Cecil, *supra* note 24, at 217; Pirog R41139, *supra* note 142, at 6.
[201] *See supra* Part III.A and accompanying notes (discussing the distinctions between integrated and non-integrated companies).
[202] Livingston, *supra* note 1, at 173.
[203] *See* Bodgdanski, *supra* note 20, at 334 (arguing that repealing certain subsidies might cause a flight of oil companies to operate abroad); Pirog R41139, *supra* note 142, at 6 (arguing that repealing percentage depletion will not affect non-integrated companies because the repeal did not affect integrated companies).
[204]*See* Livingston, supra note 1 at 174 ([l]arge size may be a prerequisite to taking very large risks, including the introduction of expensive new technologies. These considerations suggest that the government should remain neutral in the struggle between large and small").
[205] *See id*. at 173 (stating that small business are a virtuous and associated with affirmative cultural values).
[206] *Id*.
[207] *See id*. at 174 ("[a]s a general rule, the case for smallness seems strongest in industries that place a premium upon human creativity . . . arguably this is less true for, say, refrigerators or automobiles").

government.[208] The repeal is also predicted to generate $4.3 billion in revenue over the next four years, and $10 billion over the next decade.[209] This will results in large, much needed, revenue increases to the federal government.[210]

B. Intangible Drilling Costs (IDCs)

The deduction for intangible drilling costs is one of the two most controversial deductions to consider repealing.[211] Overall, IDCs should be repealed because of the circumstances in which this deduction originated.[212] Historically, drilling was considered an extremely high-risk venture because drillers, at high costs, were literally drilling into a black hole.[213] Yet today, that risk has been dramatically decreased due to technological advances, including 3-D seismic imaging and horizontal drilling.[214]Remaining costs associated with the reduced risk can be reasonably offset by capitalization instead of straight deductions.[215]

Repealing this deduction is beneficial to the federal government and non-oil and gas industry as it is estimated that the government will gain an additional $11.6 billion in revenue between 2010 and 2019.[216]

Some tax subsidy supporters speculate that a repeal will lead to job loss and reduce national job security.[217] Others, however, believe that those claims are largely unsupported by

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[208] Riti, *supra* note 112, at 809 (relating that the current oil and gas tax subsidies are "in effect . . . handouts to matured industries").
[209] Pirog R41139, *supra* note 142, at 6.
[210] *Id*.
[211] Cecil, *supra* note 24, at 223-24. The other controversial deduction is percentage depletion. *Id*.
[212] *Id*.
[213] *Id*.
[214] *Id*.
[215] Cecil, *supra* note 24, at 223-24. *See supra* Part II.B. (this is an option already available to oil and gas companies, although few choose to exercise this option because deduction is much more attractive than capitalization).
[216] *See* OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, TERMINATIONS, REDUCTIONS, AND SAVINGS, IN BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2010, at 47 (2010), *available at* http://www.gpoaccess.gov/usbudget/fy11/pdf/trs.pdf.

empirical evidence.[218] In fact, there has been little, or even no, empirical evidence presented regarding how much profit or jobs might be lost by a repeal of this tax subsidy.[219] Data such as this would be helpful in assessing actual damages that might be caused by the repeal, instead of purely speculating that damages.

Naturally, in order to fairly accommodate a deduction that has existed for a century,[220] these changes should be instituted gradually.[221] For example, changes can be implemented through early communication of any upcoming repeals and then the repeal can be instigated through phases.[222] Or, the requirements of what constitutes a non-integrated company can continually become more restrictive, until the category is basically irrelevant.[223] Eventually, after gradual implementation of the repeal, the IDC repeal can be completed.

C. Domestic Manufacturing Activity

The tax subsidy for Domestic Manufacturing Activity has been largely utilized to support the declining American industry of manufacturing.[224] The policy behind the tax subsidy for domestic manufacturing activity was to increase domestic jobs.[225] Yet, while manufacturing in America has continued to decline in activity and profit, oil and gas companies are experiencing

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[217] *See* OIL AND GAS TAX PROVISIONS, *supra* note 124 (statement of Buddy Kleemier, Chairman, Independent Petroleum Association of America) (parenthetical).
[218] Cecil, *supra* note 24, at 219 (stating that most objections regarding stated job loss and economic downturn consequences due to the repeal of tax subsidies are mere "puffery").
[219] *See e.g., id* (inferring that the consequences job loss and economic downturn upon the repeal of the oil and gas tax subsidy is mere speculation).
[220] *See supra* Part II.B (noting that percentage depletion has existed since 1918).
[221] *See* Cecil, *supra* note 24, at 226 ("Although the industry as a whole is unlikely to be affected . . . smaller oil and gas companies may struggle if the repeal of intangible drilling cost deductions and percentage depletion are enacted too quickly").
[222] *See id*. (applying the idea of implementing changes through phases to the definition of non-integrated companies).
[223] *See supra* Part II.B (describing what constitutes an non-integrated oil and gas company).
[224] Pirog R40715, *supra* note 76, at 4.
[225] Pirog R41139, *supra* note 142, at 4.

Back to Table of Contents

record-high profits.[226] Arguments against repealing this subsidy state that investment capital will decrease, causing detriment to the American economy and national security.[227] However, this argument is untenable because oil and gas companies are continuing to prevail, especially as prices remain consistently high.[228]

Another argument for repealing the domestic manufacturing subsidy for oil and gas is that domestic production of oil and gas is much more advantageous than some other types of manufacturing because of the high cost of transportation associated with importing oil and gas.[229] The transportation cost of importing oil includes not only the physical cost of transportation, but also the costs associated with political uncertainty,[230] terrorism,[231] and even natural disasters.[232] The positive advantages of the "safe" nature of domestic manufacturing, or extracting, of oil far outweigh the six percent benefit derived from the subsidy.[233] Therefore, there is little fear of a decrease in domestic production due to the repeal of this tax subsidy.[234]

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[226] *Id*. at 4-5; Pirog R40715, *supra* note 76, at 4.
[227] OIL AND GAS TAX PROVISIONS, *supra* note *124*, at 2 (statement of Alan B. Krueger, Assistant Secretary for Economic Policy and Chief Economist, United States Department of the Treasury).
[228] *See supra* note 226 and accompanying text (noting that high oil and gas prices mean that domestic manufacturing subsidies do not affect domestic investment).
[229] *See* Jim Efstathiou, Keystone Pipeline Backers Press Obama for Decision in Week, BLOOMBERG BUSINESSWEEK, (Jan. 12, 2012, 11:36AM) http://www.businessweek.com/news/2012-01-12/keystone-pipeline-backers-press-obama-for-decision-in-week.html (investing the affect of the political tension between Iran and America on energy security); Institute for the Analysis of Global Security, *Threat to Oil Transport*, (Jan. 12, 2011, 2:11PM) http://www.iags.org/oiltransport.html (suggesting that factors such as terrorism lead to increased risk of energy supply, and thereby increased cost of transporting oil).
[230] *See* Efstathiou, *supra* note 193 (arguing that the rise of political unrest between Iran and America worries Americans about the cost of oil).
[231] Institute for the Analysis of Global Security, *Threat to Oil Transport*, http://www.iags.org/oiltransport.html (last visited Jan. 16, 2012) (suggesting that factors such as terrorism lead to increased risk of energy supply, and thereby increased cost of transporting oil).
[232] *See* Knowledge@Wharton, *Crude Reality: Why High Oil Prices Are Here to Stay*, (Mar. 16, 2011), http://knowledge.wharton.upenn.edu/article.cfm?articleid=2732.
[233] *See supra* Part V.C (arguing for the repeal of the domestic manufacturing subsidy).
[234] *Id*.

Back to Table of Contents

D. Geological and Geophysical Expenses

Most arguments suggest that the current two-year amortization schedule deduction allowed for nonintegrated companies be increased to seven years, like integrated companies.[235] However, generous deductions for geological research may be the key to balancing the costs associated with repealing other oil and gas tax subsidies.[236] One of the justifications for repealing many subsidies is that drilling for oil and gas is no longer the same experience as it was before the 1950s.[237] Those days of drilling into "black holes" are gone.[238] Current technology, including seismic 3-D imaging and other technological advances, reduces much of the risk associated with exploration and drilling.[239] Technology is the key to lowering risks and costs in producing oil.[240]

Additionally, new technological advances in extraction have increased the volume of oil and gas available to the public.[241] One example of this is the oil sands of Canada.[242] Oil sands were previously too costly to be mass-produced, but as oil prices continued to rise, it become economical to fund multibillion-dollar research into their extraction.[243] Because of this research, Canada could become a new energy superpower, and America could become its number one

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[235] *See, e.g.*, Cecil, *supra* note 24, at 217-218 (suggesting that nonintegrated companies geo-research deductions should match integrated company standards).
[236] *See supra* Part II & V (listing all tax subsidies that should be repealed).
[237] *See supra* Part IV.A (noting that the risk associated with drilling is substantially reduced due to technological drilling and imaging advances).
[238] *See* Starkman, *supra* note 23, at 189 (recounting the historical attitude risks to current risks taken by oil and gas drillers).
[239] *Id.*
[240] *See generally*, Krauss, *supra* note 150 (arguing that new oil and gas technology is currently in it's infancy and is predicted to change the course of the fossil fuel future).
[241] *See e.g.*, Krauss, *supra* note 154 (explaining the story behind the technological advances associated with oil sands and other extraction techniques).
[242] *Id.*
[243] *Id.* Over $120 billion dollars has been invested in this "mega-resource". DANIEL YERGIN, THE QUEST: ENERGY, SECURITY, AND THE REMAKING OF THE MODERN WORLD 256 (1st ed. 2011)

partner.[244] Technological advances have affected prices, supply, and even stability by providing America a potential pseudo-domestic trading partner in Canada.[245] Although trading with Canada does not necessarily entail "energy independence," the political environment surrounding agreements and deals with them are much friendlier than with the Middle East.[246]

The Orinoco belt in the interior of Venezuela presents a similar story.[247] The production of this unconventional oil was difficult to and costly – too costly for the State of Venezuela to pursue alone.[248] So in the 1990s, they invited other international companies to collaborate in a joint venture, investing upwards of $20 billion.[249] After some pushing, especially in the technology arena, production is up to 600,000 barrels a day, with more likely to come.[250]

Technological advances in geological research also affect the environmental impact of exploration and extraction.[251] Several factors, such as the growth in supply and ability to extract the resources, show that the fossil fuel age could persist for much longer than originally anticipated.[252] The industry is continuing to find new sources, including oil sands, deep water reserves, shale rock, and artic reserves.[253] The industry is also finding new and advanced ways to

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[244] *Id*.
[245] *Id*.
[246] *Id*.
[247] *See* YERGIN, *supra* note 247, at 257–59 (narrating the story of the production of Orinoco oil).
[248] YERGIN, *supra* note 247, at 258.
[249] *Id*.
[250] *Id*. at 259.
[251] *See* DANIEL YERGIN, THE QUEST: ENERGY, SECURITY, AND THE REMAKING OF THE MODERN WORLD 257 (1st ed. 2011) ("technology for producing oil sands continue to evolve, and increasing ingenuity is being applied to shrinking the environmental footprint and reducing the CO_2 emissions in the production process").
[252] Krauss, *supra* note 150.
[253] *Id*.

extract these resources in methods unimaginable even as recent as a decade ago.[254] And with this growth in supply, environmentalists are demanding that extraction, transportation, and exploration are performed in ways that leave smaller footprints.[255]

Generally, increasing production of oil and gas equates to increasing pollution.[256] For example, oil sand extraction causes many environmental concerns due to the destruction of boreal forests and the release of carbon due to refining methods.[257] But just because the fossil fuel age may continue indefinitely doesn't mean the environment must continue deteriorating, especially at this rate.[258] The solution to reducing environmental impact may be efficiency, also nicknamed the "fifth fuel."[259] As shown, technological improvements have streamlined the refinement process causing less carbon emissions, and the use of steam injections has left a smaller footprint of damage to forests.[260] These advances have also partnered with the technological advancement of more efficient cars, airplanes, and homes, synergizing the effects of these technological advances.[261] However, without economic incentives such as tax breaks, oil companies are less likely to direct generous funds towards research, especially in regards to

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[254] *Id*. *See e.g.*, DANIEL YERGIN, THE QUEST: ENERGY, SECURITY, AND THE REMAKING OF THE MODERN WORLD 255 (1st ed. 2011) ("[i]t was not until the late-1990s that the oil sands finally began to prove themselves as a large-scale commercial resource").

[255] *See, e.g.*, John M. Broder & Dan Frosh, *Politics Stamps Out Oil Sands Pipeline, Yet it Seems Likely to Endure*, N.Y. TIMES (Dec. 23, 2011), http://www.nytimes.com/2011/12/24/us/provision-may-halt-keystone-pipeline-but-oil-is-still-likely-to-flow.html (mentioning environmentalists' protests outside the White House against the Keystone Pipeline).

[256] *See* Krauss, *supra* note 150 (describing the research advances related to lowering the carbon footprint of oil sand extraction).

[257] *Id*.

[258] *Id*.

[259] YERGIN, *supra* note 247 at 614–15.

[260] Krauss, *supra* note 150.

[261] *See* YERGIN, *supra* note 247 at 615, 621–22 (illustrating, as examples, that a combination of more efficient cars, housing, industry, and airplanes has resulted in America's "lighter" economy).

environmental concerns.[262] This illustrates that tax subsidies should be reserved for purposes that cannot be driven by the market alone.[263]

Another reason why the amortization schedule for oil and gas research should be left alone, or even increased, is that research should be an encouraged industry in America.[264] Generally, the taxpayer can make an election to deduct or capitalize research and experimental expenditures.[265] This is allowed even though research costs can potentially lead to future profits, and any costs that lead to future profits are mainly capitalized.[266] One can infer that research, as a good social policy, is one of the reasons for allowing this taxation anomaly.[267] This reason is also supported by the groundbreaking technological advances demonstrated by geologist and geophysicists, who have drastically lowered the cost and risk of obtaining oil while simultaneously increasing the supply.[268]

Lastly, one of the greatest fears of repealing oil and gas tax subsidies is the increase in prices that consumers may experience.[269] Especially upon recalling the national outcry when gas

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262 *See* YERGIN, *supra* note 247 at 255 (reflecting on the theory that Canada's high-tax national energy policy resulted in the abandonment of oil sand exploration in the 1970s and that a tax reform in the 1990s revived interest, resulting in major technological advancements).
263 *Id* at 625 (conveying that there is less incentive to invest in environmental ventures that do not result in some sort of ceremony, or "cut[ting] a red ribbon").
264 *See* Livingston, *supra* note 1, at 218 (recalling the social benefits of research, such as national pride and identification of Americans towards technological advancement and the belief that it is the "modern equivalent of the frontier.")
265 GRAETZ, *supra* note 3, at 335–36.
266 *See id.* at 336 (inferring that an anomaly exists when Congress allows a deduction for a cost that should be otherwise capitalized).
267 *Id.*
268 *See generally,*
269 *See generally* Dillon, *supra* note 33, at 54 (discussing consumer fear of suffering the consequences of high oil and gas prices and who should actually bear those costs, suppliers or consumers).

prices rose above four dollars a gallon.[270] Although complicated arguments about whom should bear the rising costs of oil and gas ensues (the government, the supplier, or the consumer?),[271] research and technology advances can offset rising costs.[272] For example, suppose domestic shale rock and Canadian oil sands become a more viable source of oil and gas.[273] Prices for oil and gas could decrease or remain stable, just through the political stability of those oil and gas sources.[274] This can be credited to the formerly unimaginable technological advances in geological research.[275]

That being the case, Congress should think twice before blindly repealing any and all advantageous oil and gas tax subsidies. Subsidies for geological research and technology can be differentiated from other oil and gas tax subsidies in the way it affects certain aspects of oil and gas that the other tax subsidies do not.[276] Some of the ways that research affects other facets of

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[270] Diane Cardwell, *Oil Prices Predicted to Stay Above $100 a Barrel Through Next Year*, N.Y. TIMES, (Dec. 28, 2011) http://www.nytimes.com/2011/12/29/business/oil-prices-predicted-to-remain-above-100-a-barrel-next-year.html (stating that four dollar a gallon as a "price shock" and forced Americans to change the way they consume gas, resulting in cutbacks in driving).

[271] *See generally* Dillion, *supra* note 33, at 54 (suggesting that suppliers should bear the grunt of the cost, not consumers).

[272] *See generally* Krauss, *supra* note 150 (explaining that technological advances are lengthened the fossil-fuel age because increasing supply and lowered prices have shifted the focus away from alternative energy back to fossil fuels).

[273] *See id.* (introducing unconventional forms of oil and gas, such as shale rock and oil sands).

[274] *See* YERGIN, *supra* note 247, at 268 (suggesting that what we are really looking for is not energy independence, but energy "security"). *See* Krauss, *supra* note 150 (suggesting that a partnership with Canada over the oil sands would be politically stable).

[275] *See generally* Krauss, *supra* note 150 (recalling examples of technological advances that have given rise to greater access to oil and gas in areas previously off-limit); YERGIN, *supra* note 247, at 253–259 (narrating the technological and economic struggles faced by those in Canada and Venezuela to develop their domestic oil sources).

[276] *See supra* Part II.A–I (listing all subsidies that could be repealed). *But see supra* Part II.D, Part IV.D (describing the tax subsidy for geological and geophysical costs and why they should not be repealed).

Back to Table of Contents

oil and gas include lowering the environment footprint and prices, while increasing efficiency and supply, and generally promoting the social good of research, science, and knowledge.[277]

On the other hand, one could explore a middle ground solution between increasing the geological and geophysical amortization period[278] and allowing immediate cost deduction by allowing deductions for research and exploration with a "green" effect. For example, costs related to exploration, drilling, or refining that involve low-carbon emissions or other methods that are environmentally friendlier, should be deducted immediately.

E. Passive Loss Exceptions For Working Interests

Passive loss exceptions for working interests should be repealed because most investors in this category do not actually have what is commonly known as "working interests."[279] Most of these types of investors are not actually burdened by the cost of development and operation of the oil and gas projects.[280] For example, the requirements of a person who "materially participates" in an activity are notably more stringent than the what is expected of a working interest owner of an oil and gas well.[281] In order to materially participate, one must either spend more then 500 taxable hours per year on the activity, perform substantially all of the activities of a typical "material participant," equal or exceed the participation of others, participate for any

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[277] *See generally* Krauss, *supra* note 150 (explaining how technological advances have increased supply, thereby lowering prices for oil and gas).
[278] *See* Pirog R41139, *supra* note 142, at 5 (discussing arguments for increasing the amortization period for geological and geophysical research).
[279] *See* Cecil, *supra* note 24, at 217-18 (listing examples of these types of investors are ones involved in production payments, overriding royalties, and certain contract rights).
[280] *Id.*
[281] GRAETZ, *supra* note 3, at 415. *See supra* Part II.E (listing the ownership qualifications of a generic taxpayer who "materially participates" in an income-producing activity).

Back to Table of Contents

five of the last ten prior years, materially participate in a "service activity," or prove by facts and circumstances that he or she is a material participant.[282]

The reasons for repealing this subsidy are numerous and compelling. First, investments should be formed based on market information, not tax incentives.[283] Second, this repeal could be a disincentive for investing solely to use oil and gases losses to offset other income.[284] And third, market supply and demand provides enough incentive to investors without the aid of this subsidy.[285]

F. Deductions for Tertiary Injections

Provisions that are out-of-date and underutilized (or not utilized at all in this case) should be repealed in order to maintain modern, not archaic, laws and codes.[286] However, this may entail the use legislative resources that could be directed elsewhere.[287] Hence, deductions for tertiary injections provides an example of why some tax subsidies should include sunset provision, otherwise known as sunset laws.[288] Sunset provisions will force lawmakers to

282 *Id.*
283 Cecil, *supra* note 24, at 217.
284 *Id.*
285 *Id.*
286 *See* Starkman, *supra* note 21, at 191 ("[w]e now have an opportunity to revisit all the 100-year-old tax bounties conferred on a small group of preferred taxpayer"); *Id.* at 192 ("[t]his anachronistic tax policy is overdue for a thorough review").
287 *See* LOWE, *supra* note 54, at 332 (speculating that one of the reasons why beneficial oil and gas taxes remain is because no sunset provisions were attached).
288 *See* LOWE, *supra* note 54, at 332 *(speculating that one of the reasons why beneficial oil and gas taxes remain is because no sunset provisions were attached).* Sunset laws are statutes under which a governmental agency or program automatically terminates at the end of a fixed period unless it is formally renewed. BLACK'S, *supra* note 59 at 680.

constantly reevaluate the purpose and justification associated with every credit or deduction provided.[289]

Others may argue that carbon dioxide injections are beneficial for the environment or may cause oil and gas prices might to drastically fall.[290] However, these exceptions are under-inclusive and, once again, highly unlikely.[291]

G. *LIFO Inventory Accounting*

The LIFO Inventory Accounting principle for oil and gas companies should be repealed to make taxes fairer.[292] The most common methods of accounting are the accrual method and the cash method, respectively.[293] The purpose of accounting methods is to accurately reflect the financial state of a company.[294] Oil and gas companies should not use an accounting method that distorts and potentially exacerbates their profits, especially in times of rising oil and gas prices.[295] Additionally, LIFO should be repealed to promote consistent accounting amongst all oil and gas companies, especially because LIFO is not an internationally accepted standard,[296] and oil and gas is part of a worldwide market.[297]

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289 *See* Ohio Legislative Service Commission, *Legislative Oversight*, 2012, at 75, *available at* http://www.lsc.state.oh.us/guidebook/chapter7.pdf ("The purpose of a sunset provision is to force a systematic evaluation of an agency or program by establishing a specific date for the termination of the law creating the agency or program)"
290 Cecil, *supra* note 24, at 219.
291 *Id*.
292 Johnson, *supra* note 77, at 582–83.
293 GRAETZ, *supra* note 3, at 672.
294 *Id*.
295 *See supra* Part II.G (noting that the LIFO accounting method is more advantageous during times of rising prices).
296 GRAETZ, *supra* note 3, at 672.
297 *See*, Krauss, *supra* note 150 ("demand for energy is going to increase by 50 percent by 2035, largely because of increased consumption in China, India and the rest of the world").

Back to Table of Contents

H. Pool of Capital Doctrine and Carried Interests

The Pool of Capital Doctrine and Carried Interests should be repealed because it goes against the general tax rule without a compelling reason.[298] Although no cash has been exchanged, it has long been established that barter exchanges, or non-cash exchanges, are a taxable event.[299] And in this case, there is an exchange for an underlying asset, the interests in the oil or gas, which should be taxable.[300] More specifically, the fair market value of both sides of the transaction should be taxed.[301] That means including in income, the recipient who is receiving compensation for goods, services, and the use of their property, and the transferor who is exchanging the interest in the oil or gas for those goods, services, and property use.[302] The repeal of this subsidy would result in a fairer tax.[303]

In some cases, non-cash exchanges, such as Like-Kind Exchanges, can be exchanged without a taxable realization event, until that Like-Kind Property is eventually sold.[304] This is done primarily to protect taxpayers who have no cash and to avoid the difficulty of valuing these trades.[305] Now compare the oil and gas industry's situation to that of the poor farmer, exchanging land and trucks.[306] The difference between the two is that oil and gas companies do

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[298] Johnson, *supra* note 77, at 574.
[299] I.R.C. § 6045(c)(1)(B) (2006); GRAETZ, *supra* note 3, at 103, 130.
[300] Johnson, *supra* note 77, at 574; *see also supra* Part II.H (addressing tax policy which usually require the tax recognition of cashless exchanges).
[301] Bodgdanski, *supra* note 20, at 328.
[302] *Id*.
[303] *Id*; *see also* Johnson, *supra* note 77, at 574.
[304] GRAETZ, *supra* note 3, at 636.
[305] *Id*. at 641.
[306] *See generally id*. (referring to examples of land and trucks in like-kind exchanges).

Back to Table of Contents

not lack either cash or the ability to value their product.[307] Therefore, the policy reasoning behind this subsidy does not stand, especially due to the growing prosperity of oil and gas companies.[308]

I. *Credit for Enhanced Oil Recovery Costs and Marginal Well Tax Credit*

The easiest tax deductions to cut are the ones that are currently not utilized, have not been utilized for some time, and will most likely not be utilized in the next decade.[309] That means that the credit for enhanced oil recovery costs[310] and marginal tax credit[311] can be confidently repealed.[312] Both of these credits are utilized only during periods of low prices, which will most likely not be reached as long as the U.S. continues to consume oil and gas at its current rate.[313]

V. CONCLUSION

Most of the tax subsidies for oil and gas companies should be repealed in order to create a fairer tax system,[314] sway investors towards alternative energy,[315] and raise revenue for the

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[307] *See* Energy and Oil Prices, BLOOMBERG (last visited Feb. 25, 2012, 10:47PM), http://www.bloomberg.com/energy/ (listing current oil and gas prices).
[308] Bodgdanski, *supra* note 20, at 328; *see also* Johnson, *supra* note 77, at 574. *See supra* note 29 and accompanying text (listing ExxonMobil, Chevron, and ConocoPhillips as three of the top twenty-five largest public companies in the world.)
[309] *See* OIL AND GAS TAX PROVISIONS, *supra* note 124 (statement of Alan B. Krueger, Assistant Secretary for Economic Policy and Chief Economist, United States Department of the Treasury); Cecil, *supra* note 24, at 215-16.
[310] *See supra* Part II.I (describing the credit for enhanced oil recovery cost is currently under utilized).
[311] *See supra* Part II.J (describing the credit for marginal tax is currently under utilized).
[312] Cecil, *supra* note 24, at 215-16.
[313] *See supra* Parts II.I-J (addressing that both of these subsidies are underutilized because prices are too high).
[314] *See supra* Part III (arguing that one of the reasons for repealing oil and gas subsidies is to create a more even playing field amongst industries, such as the alternative energy industry compared to the oil industry).
[315] *See id.* (arguing that oil and gas subsidies must be relinquished because the disparity in investing in oil and gas compared to alternative energy is already so great).

federal government.[316] However, subsidies towards geological and geophysical research should not be repealed.[317] This is because research has benefited exploration and extraction by increasing supply and efficiency, and decreasing pollution.[318] And, research has also diminished one of the reasons for which many of these subsidies were created in the first place, the industry's high-risk nature.[319]

And yet, while repealing these tax subsidies taxes may immediately increase revenue and create a fairer tax system,[320] many other factors must fall into place if society is to increase its usage of alternative energy.[321] To do so, society must reduce oil and gas consumption, mainly by embracing alternative-energy cars.[322] But at the current moment, progress towards alternative energy solutions may be prolonged because the supply of oil and gas is rising,[323] as is demand.[324]

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[316] *See id*. (reiterating that experts predict an increase in $36 billion in the next decade, if oil and gas subsidies are repealed).

[317] *See supra* Part IV.D (arguing that geophysical and geological research may offset the possibility of price increase and foreign oil dependence which may result from the repeal of other oil and gas subsidies).

[318] *See supra* Part IV.D (recalling the advances that research has made towards the extraction of oil from Canadian oil sands, and gas from American shale rock, among others).

[319] *See* Parts IV.A-B (noting that percentage depletion and intangible drilling costs, two of the most commonly used oil and gas subsidies, were primarily implemented to reduced the risk of drilling to "place holes").

[320] *See supra* Part III (noting that both of these results are highly likely, as forecast by many analysts and industry experts).

[321] *See id*. (noting that a decrease in investment in oil and gas does not equate an increase in investment into alternative energy).

[322] *See* YERGIN, *supra* note 247, at 709–710 (explaining the possibilities of "the car[s] of the future"). Cars release 17 percent of the carbon emissions in the atmosphere. *Id*. at 693.

[323] *See* YERGIN, *supra* note 247, at 227-28, 237 (1st ed. 2011) (explaining that throughout history, experts have predicted the end of the oil supply, but as technology continues to expand on the availably of oil, the plateau on oil will only begin in the 2050s).

[324] *See* Krauss, *supra* note 150 (projecting oil and gas supply to increase as access increases due to technological advancements in extraction and refinement).

Nevertheless, these first steps are crucial towards the development of an energy-efficient future.[325]

[325] *See* YERGIN, *supra* note 247, at 614 ("One energy resource has the potential to have the biggest impact of all . . . It goes by different names–*conservation, energy efficiency, energy productivity*").