Texas Tax Lawyer

A Tax Journal

Winter 2021 • Vol. 48 • No. 2

TAX SECTION
STATE BAR OF TEXAS

www.texastaxsection.org

TABLE OF CONTENTS

PRACTITIONER'S CORNER:

- Property Tax Litigation Update: Courts Are Limiting the Scope of Discovery in Equal and Uniform Lawsuits
  Stephen Grant, Popp Hutcheson, P.L.L.C.

- New User Fee Proposed for Estate Tax Closing Letters
  Rebecca Warren, RSM US LLP
  Lee Ann Couture, RSM US LLP

- Property Tax Update
  John Brusniak, Brusniak Turner Fine, L.L.P.
  Chris Arnell, Brusniak Turner Fine, L.L.P.

- Overview of Outbound International Tax Rules
  John T. Woodruff, Polsinelli, P.C.

- Year-End 2020 Legislative and IRS Developments for Benefits Plans
  Felicia A. Finston, Wilkins Finston Friedman Law Group, L.L.P.
  William M. Fisher, Wilkins Finston Friedman Law Group, L.L.P.
  Linda A. Wilkins, Wilkins Finston Friedman Law Group, L.L.P.

- The Department of Justice Announces First Guilty Please in Conservation Easement Transactions
  Michael A. Villa, Jr., Meadows, Collier, Reed, Cousins, Crouch & Ungerman, L.L.P.

- Texas Tax Quarterly Update, 4th Quarter 2020
  Gordon Martens, Martens, Todd & Leonard

Committee on Government Submissions:

- Comments Regarding Proposed Regulations on the Centralized Audit Regime
  Committee on Government Submissions

Section Information:

- 2020 – 2021 Calendar

- Tax Section Leadership and Council Roster

- Tax Section Committee Chair and Vice Chair Roster

Dear Fellow Tax Section Members:

As we are all keenly aware, the past year has thrown the whole world for a bit of a loop. I am delighted to report that the Tax Section has been busy at work on behalf of our members. I have included highlights of our activities below.

Thank you to our Texas Tax Lawyer editor, **Aaron Borden**. We hope you benefit from the informative and interesting articles included in this edition.

Tax Section Annual Meeting

The bar has recently announced that the 2021 Annual Meeting will be held via Zoom once again this year. Details are still being worked out, but rest assured that the Tax Section will be having programming on Friday, June 18, 2021. There is sure to be an outstanding line up, so please mark your calendars now and plan to attend! More details to come.

First Wednesday Tax Update

Bruce McGovern, Professor of Law and Director, Tax Clinic, South Texas College of Law Houston, continues to provide his popular monthly tax update.

Below are some important reminders about the Monthly Update.

- The registration link is sent via eblast about a week before the first Wednesday of the month.
- The registration link can also be found at the Texas Tax Section website a week before the update.
- A member cannot sign up for the update once the live broadcast has begun.
- If for any reason you do not receive the eblast, you can register by going to the Texas Tax Section website.
- Members are required to self-report their CLE credit as we are unable to report on your behalf due to the virtual nature of the presentation. The CLE number will be provided in both an email to all registrants and at the end of the update.
- The recorded program is posted online in the 24/7 Library a few weeks after the live program. Members can log in to the Texas Tax Section website to watch it for CLE credit.

Annual Comptroller Briefing

The Annual Comptroller Briefing that is jointly sponsored by the Texas Comptroller's Office and Tax Section was held virtually on January 12-14, 2021 and was a resounding success. Thanks to the SALT Committee leadership for coordinating and participating in the event.

Tax Law in Day

Tax Law in a Day is a seminar specifically designed to provide information on a wide variety of basic tax topics. **Renesha Fountain**, Tax Section Council member, and **Harriet Wessel**, coordinated this year's Tax Law in a Day, which was held as a virtual meeting over two days, February 4 and 5, 2021. The programs were outstanding and we had record attendance. A special thanks to all of the speakers for sharing their knowledge and to Renesha and Harriet for their leadership!

A Deep Dive into the Carried Interest Regulations

An advanced tax law webinar that focuses on the Carried Interest Regulations will be held via Zoom on April 23, 2021 from 10:30 a.m. to 2:30 p.m. Chair-Elect **Dan Baucum** is coordinating the programming, and it will be a program you will not want to miss!

Committee on Government Submissions

The Committee on Government Submissions continues its work under the leadership of **Sam Megally**, **Jason Freeman**, and **Josh Prywes**.

On January 25, 2021, the Tax Section submitted comments to the Internal Revenue Service regarding the Proposed Regulations on the Centralized Audit Regime. The principal drafters of the comments were **Lee S. Meyercord** and **Jackson Oliver**. **Mary A. McNulty**, past Chair of the Tax Section and member of the Partnership and Real Estate Tax Committee, also reviewed the Comments and provided substantive suggestions. The comments are included in this edition. Lee and Jackson also testified on March 25, 2021 at a virtual hearing to provide helpful testimony to the IRS and Treasury.

The work of the COGS committee continues to ensure that new regulatory provisions work as intended and any inconsistencies can be corrected before the finalization of the regulations and rules. This is a meaningful service to our profession and to the public in general. I commend all Tax Section members who have worked so hard in this important endeavor.

Law School Outreach

The Law School Outreach Committee is responsible for visiting each law school in Texas to give a behind-the-scenes view of a tax attorney. This program has transitioned to online presentations at the law schools this year. Please see the Tax Section calendar for dates for other school visits. A special thanks to **Audrey Morris** who has diligently tracked down our busy law school coordinators to get these scheduled.

Scholarship Applications

The Law School Outreach Committee also manages the Tax Section's annual scholarship program. Professor **Alyson Outenreath** is once again coordinating this process. This year the Tax Section plans to again award up to three scholarships to law students intending to practice tax law in Texas. Applications are available now and are due on April 16, 2021. A copy of the scholarship applications is included in this edition. Please pass this along to any qualified candidates you know.

Pro Bono Committee

The Tax Section's Tax Court Pro Bono program for both Tax Court trial sessions and settlement days in advance of the trial sessions have been held virtually. Because of our robust program, we also participated by request in tax court proceedings in Nevada and Florida. Our work in this area is widely known and recognized. The recently adopted rules of professional misconduct will make helping others even easier!

The section also participated in the Adopt-a-Base program again this year, by doing extensive training at Fort Bliss, Goodfellow Air Force Base, and Joint Base San Antonio. If you are interested in participating in these worthy endeavors or have any questions, please contact a member of the Pro Bono Committee. The work of this committee is some of the most meaningful work we can do for the public. All lawyers who assist in these projects have earned my highest regard. A very special thanks to **Bob Probasco** and **Rachael Rubenstein** who have worked so hard this year in helping others.

Welcome to our new Ex Officio Council Member

Due to a change in responsibility, **James D. Arbogast**, Chief Counsel for Tax Hearings and Litigation at the Texas Comptroller of Public Accounts, has had to step down in his position with the Council, but we are happy to welcome **Bree Boyett**, Tax Litigation Attorney, as the ex officio Council Member representing the Texas Comptroller of Public Accounts.

Sponsors

We heartily thank all of our sponsors for 2020-2021. They include Sapphire Level Sponsors **Thompson & Knight** and **Chamberlain Hrdlicka**, Platinum Sponsor **Glast, Phillips & Murray**, and Gold Sponsors **Baucum Law, Davis Stephenson**, **Law Office of Catherine Scheid**, and **Mondrik & Associates**. This year was complicated for many reasons, and the Section is grateful for the continued support of these law firms during the challenging times.

Contact Information

Please feel free to contact me or our Tax Section Administrator, Anne Schwartz, if you have any questions or would like additional information about any of these items or the Tax Section in general.

Lora G. Davis
Davis Stephenson, PLLC
100 Crescent Court, Suite 440
Dallas, Texas 75201

(214) 396-8801
lora@davisstephenson.com

Anne Schwartz
Tax Section Administrator
(917) 450-6238
annehschwartz@gmail.com

2021
CALL FOR NOMINATIONS FOR OUTSTANDING TEXAS TAX LAWYER AWARD

The Council of the State Bar of Texas Tax Section is soliciting nominees for the Outstanding Texas Tax Lawyer Award. Please describe the nominee's qualifications using the form on the next page. Please attach additional sheets if needed.

Nominees must: (i) be a member in good standing of the State Bar of Texas or an inactive member thereof; (ii) a former full time professor of tax law who taught at an accredited Texas law school; or (iii) a full time professor of tax law who is currently teaching at an accredited Texas law school. In addition, nominees must have (1) devoted at least 75% of his or her law practice to taxation law, and (2) been licensed to practice law in Texas or another jurisdiction for at least ten years.[1] The award may be granted posthumously.

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; mentoring 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 Henry Talavera, Tax Section Secretary by email to htalavera@polsinelli.com no later than April 1, 2021.

---

[1] "Law practice" means work performed primarily for the purpose of rendering legal advice or providing legal representation, including: private client service; 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 but is not limited to "Tax Law" as defined by the Texas Board of Legal Specialization's standards for attorney certification in Tax Law; tax controversy; employee benefits and executive compensation practice; criminal defense or prosecution relating to taxation; taxation practice in the public and private sectors, including the nonprofit sector; and teaching taxation law or related subjects at an accredited law school.

NOMINATION FOR 2021 OUTSTANDING TEXAS TAX LAWYER AWARD

Nominee Name: ____

Nominee Mailing Address, Phone, and Email:

____

____

Description of Nominee's Contributions/Experience Relating to Taxation Law (please attach additional sheets if needed):

____

____

____

____

____

____

____

____

____

____

____

____

Nominator Name: ____

Nominator Mailing Address, Phone, and Email:

____

____

TAX SECTION
State Bar of Texas

Law Students Pursuing Tax Law Scholarship Application

The Tax Section of the State Bar of Texas annually awards up to three $2,000 scholarships to students demonstrating academic excellence and commitment to the study and practice of tax law. Any student who is enrolled in an ABA accredited law school at the time the application is submitted, and who intends to practice tax law in Texas, is eligible to apply. Thus, persons who have been accepted to law school, but have not yet started classes at the time the application is filed, are ineligible to apply. However, persons who have recently graduated at the time the scholarship is awarded are eligible to apply.

The purpose of this scholarship is to facilitate and encourage students to enter the practice of tax law in Texas, and to become active members of the State Bar Tax Section, by assisting these students with their financial needs. Selection criteria of the scholarships include: merit, scholarship performance, financial need, and demonstrated experience and interest in the field of tax law. Consideration is also given to extracurricular activities both inside and outside law school, including but not limited to legal externships or internships with state or federal taxing authorities such as the Internal Revenue Service, Office of the Texas Comptroller of Public Accounts, or Texas-based legal aid societies and clinics.

A completed application must be returned by email to Alyson Outenreath at Alyson.Outenreath@ttu.edu.

<u>All information, including supporting documentation such as letters of recommendation and transcripts, must be included in a single submission. Transcripts do not need to be in original or certified form. Please scan all of the documents and attach the scan to an email as a single document in PDF form. Incomplete applications will not be accepted.</u>

Applications must be time stamped by no later than **April 16, 2021**. The scholarships will be awarded at the State Bar Annual Meeting in June 2021 in Fort Worth, Texas if the meeting is held in person. Winners need not be present to accept the award.

Please print or type.

I. GENERAL INFORMATION

NAME: ____

E-MAIL ADDRESS: ____________________________

MAILING ADDRESS: ____
____

CELL PHONE: ______________________ ALTERNATE PHONE: ______________________

II. EDUCATIONAL INFORMATION

LAW SCHOOL NAME: ____

GPA (cumulative): ____________ EXPECTED GRADUATION DATE: _________

CLASS RANK: _________

UNDERGRADUATE COLLEGE NAME: _______________________________________

DEGREE: ___ MAJOR: __________ GPA: _____ GRADUATION DATE: ______

GRADUATE DEGREES including LL.M. Programs (College, Degree, Date):

____

____

Please attach a copy of all college, graduate school (if any), and most recent law school transcripts. If your law school transcript does not include your grades for the most recent closed grading term, please separately provide information on all grades you have received to date and supplement your application with remaining grades as soon as possible after you receive them.

LAW SCHOOL ACTIVITIES AND/OR HONORS:

COMMUNITY ACTIVITIES:

Responses regarding law school activities and/or honors and community activities may be made in typewritten form of no more than one page in length.

III. RECOMMENDATIONS AND ESSAY

Please attach (1) one or more letters of recommendation and (2) a typewritten essay of no more than two pages in length (double spaced) addressing the following:

- Why you plan to pursue a career in tax law in Texas;
- What are your long-term career goals;
- List of the tax courses you have completed and grade received, and tax courses you are currently taking; and
- Any qualifications that you believe are relevant for your consideration for this scholarship. For example, students may describe relevant research, published articles, clubs, competitions, clinics, community service, job or internship or externship experience.

- (Optional) Any issues of financial need that you would like the Committee to consider.

AFFIRMATION OF APPLICANT: By signing below, I certify that all the information provided as part of this application is true and correct. I understand that the Tax Section's Scholarship Selection Committee reserves the right to investigate all information stated in this application.

Applicant's Signature: ________________________________ Date: ______________

CFC is Now the Place to Be for Theft Losses, Worthless Losses, and Other Section 165 Losses

By Mary A. McNulty and Jackson L. Oliver*

The Federal Circuit recently issued a taxpayer-favorable opinion on a section 165 loss issue. Taxpayers considering filing suit on a theft loss or other section 165 loss, such as a loss for worthless securities, should consider filing a refund suit in the Court of Federal Claims because of the binding Federal Circuit precedent in *Adkins*. The opinion is available here. Other courts may continue to apply the "unknowable" standard, which would delay when the loss may be deducted.

Background

Section 165(c)(3) allows noncorporate taxpayers to deduct certain losses arising from theft in the year in which the theft is discovered. However, if the taxpayer has a claim for reimbursement for which a reasonable prospect of recovery exists, no portion of the loss is deductible until the tax year that the reimbursement amount can be determined with reasonable certainty.[1]

Between 1997 and 2002, Charles and Jane Adkins (the "Taxpayers") invested in securities with Otto Kozak and his brokerage firm (collectively, the "Brokers"). Unbeknownst to the Taxpayers, the Brokers were operating a "pump-and-dump" scheme that diminished nearly the entire value of the Taxpayers' original multi-million dollar investment portfolio. In 2006, when arbitration and criminal proceedings against the Brokers became stagnant, the Taxpayers filed a refund claim for their 2004 tax year claiming a multi-million dollar theft loss deduction. The IRS disallowed the refund claim, and the Taxpayers filed suit in the United States Court of Federal Claims.

Court of Federal Claims' Decision

The Court of Federal Claims held that the Taxpayers could not establish that they were entitled to the theft loss in 2004 because the reasonable prospect of recovering their losses was simply unknowable by the end of 2004. The Court of Federal Claims pointed to evidence showing three different pending avenues of recovery in 2004—two arbitration claims and criminal restitution. The Court of Federal Claims required objective evidence to show that the Taxpayers had no reasonable prospect of recovering their losses in 2004. The Taxpayers presented only their subjective belief that the criminal proceedings in 2004 eliminated their avenues of recovery.[2]

Federal Circuit's Decision

On appeal, the Federal Circuit found that the Court of Federal Claims misconstrued the legal standard in assessing the Taxpayers' reasonable prospect of recovery.[3] The Federal Circuit disagreed that a taxpayer cannot establish the lack of a reasonable prospect of recovery when it is "unknowable" at the time of the loss deduction. The applicable Treasury regulation requires only that a taxpayer have "no reasonable prospect of recovery," not affirmative proof that that the loss would never be recovered.[4] Further, the Federal Circuit found no requirement that a taxpayer

* Mary A. McNulty is a partner in the Dallas office of the law firm Thompson & Knight L.L.P. and can be contacted at mary.mcnulty@tklaw.com. Jackson L. Oliver is an associate in the Dallas office of the law firm Thompson & Knight L.L.P. and can be contacted at Jackson.Oliver@tklaw.com.

exhaust every possible avenue of recovery, regardless of cost or the likelihood of success, and reasoned that such a requirement would be contrary to the regulations allowing abandonment of a claim.[5] In addition, the taxpayer, with the assistance of counsel, is in the best position to evaluate the claims worth pursuing. After reviewing the evidence, the Federal Circuit concluded that the Court of Federal Claims clearly erred in holding that the Taxpayers failed to prove they had no reasonable prospect of recovery in 2004 and remanded the case for a calculation of the Taxpayers' refund.

Implications

The Federal Circuit's rejection of the "unknowability" standard provides relief for taxpayers claiming a theft loss deduction while claims against the wrongdoers remain pending. Additionally, the Federal Circuit's reasonable-prospect-of-recovery analysis may offer favorable authority in the context of the "closed transaction" requirement for establishing other loss deductions.

For example, section 165(g) provides taxpayers a worthless securities loss deduction for the tax year that the securities become completely worthless. A security generally becomes worthless when there is no reasonable expectation that the security will have any current or future value, which is often evidenced by an identifiable event.[6] As stated in *Morton v. Commissioner* (the case often examined in analyzing the existence of worthlessness), "identifiable events" include such occurrences as bankruptcy, cessation of business, liquidation of the corporation, or the appointment of a receiver.[7]

Even though a singular event may not definitely establish worthlessness,[8] identifiable events are afforded significant weight in establishing the lack of future value of a security. For example, in *Delk v. Commissioner,*[9] the Ninth Circuit found that the cancellation of original shares of a bankrupt company pursuant to a plan of reorganization was an identifiable event where a shareholder contributed capital to acquire new shares in the reorganized company and realized a loss on the old shares. Additionally, in TAM 9223001, the IRS held that the decision to discontinue a subsidiary's operations was an identifiable event indicating that the subsidiary's stock became worthless during the tax year, even though the subsidiary continued to fulfill existing commitments.

Based on *Adkins*, taxpayers should not be required to wait to deduct a worthless security loss because the future value of the security is "unknowable." Taxpayers also should not be required to show that they have exhausted every possible avenue of recouping their investment before taking the loss deduction. A taxpayer may prove that the stock of an operating company has become worthless by pointing to bleak business prospects, the need for capital infusions, significant operational changes, or reporting of discontinued operations.[10]

The lower court in *Adkins* relied on a majority opinion issued by the Tenth Circuit in *Jeppsen v. Commissioner*[11] for the argument that a taxpayer is not entitled to a loss deduction if the prospect of recovering such loss is unknowable.[12] The dissenting opinion in *Jeppsen* viewed such a standard as placing an "insurmountable barrier on the taxpayer" in proving that the loss would never be recovered.[13] After discussing the merits of both arguments, the Federal Circuit explicitly endorsed the reasoning of the dissent in *Jeppsen*. Accordingly, the Federal Circuit's favorable interpretation of the loss regulations creates a circuit split with the Tenth Circuit.[14] In addition, an unpublished opinion in the Sixth Circuit cites *Jeppsen*'s "unknowable" standard.[15]

Taxpayers considering filing suit on a theft loss or other section 165 loss, such as a loss for worthless securities, should consider filing a refund suit in the Court of Federal Claims because of the binding Federal Circuit precedent in *Adkins*. Appeals from the Court of Federal Claims lie to the Court of Appeals for the Federal Circuit. The Court of Federal Claims is a court of national jurisdiction over refund suits and is bound by Federal Circuit precedent.[16] Decisions of the Tax Court[17] and judgments of a district court[18] are appealed to the court of appeals with venue over the taxpayer by reason of residence or principal place of business. Therefore, all taxpayers—and especially those taxpayers whose appeal would lie to the Tenth Circuit or Sixth Circuit—should consider filing a refund suit in the Court of Federal Claims to avoid the "unknowable" standard for deducting a theft loss, worthless loss, or other section 165 loss that other courts may apply.

---

[1] *See* Treas. Reg. § 1.165-1(d)(2).
[2] *Adkins v. United States*, 140 Fed. Cl. 297 (2018).
[3] *Adkins v. United States*, 960 F.3d 1352 (Fed. Cir. 2020).
[4] Treas. Reg. §§ 1.165-1(d)(2)(i), (3).
[5] *Id.* § 1.165-1(d)(2)(i).
[6] *See Morton v. Commissioner*, 38 B.T.A. 1270, 1278-79 (1938), *aff'd*, 112 F.2d 320 (7th Cir. 1940) (holding that "identifiable events" include bankruptcy, receivership, cessation of business, and liquidation of the company).
[7] *Id.*
[8] *See Murray v. Commissioner*, T.C. Memo 2000-262 (2000) (foreclosure not determinative); *Osborne v. Commissioner*, T.C. Memo 1995-353 (1995) aff'd 114 F.3d 1188 (6th Cir. 1997) (bankruptcy not determinative); *Schnurr v. Commissioner*, T.C. Memo 1989-275 (1989) (cessation of business and sale of the assets not determinative).
[9] 113 F.3d 984 (9th Cir. 1997).
[10] *See, e.g.*, *Steadman v. Commissioner*, 50 T.C. 369 (1968), *aff'd*, 424 F.2d 1 (6th Cir. 1970) (stock of operating corporation deemed worthless based on corporation incurring substantial net-operating loss that eliminated all shareholder's equity in the stock); Rev. Rul. 2003-125, 2003-2 C.B. 1243 (parent corporation was entitled to worthless stock deduction on the deemed liquidation of its insolvent foreign subsidiary pursuant to a check-the-box election because the FMV of the subsidiary's assets did not exceed the subsidiary's liabilities so that on the deemed liquidation of the subsidiary the shareholder received no payment on its stock); Rev. Rul. 70-489, 1970-2 C.B. 53 (parent corporation could claim worthless security deduction, despite parent continuing the business formerly conducted by subsidiary, where subsidiary had bona-fide indebtedness to parent that exceeded fair market value of its assets and the subsidiary transferred all of its assets to its parent in partial satisfaction of its indebtedness).
[11] *Jeppsen v. Commissioner*, 128 F.3d 1410 (10th Cir. 1997).
[12] *Adkins*, 140 Fed. Cl. at 313 (citing *Jeppsen*, 128 F.3d at 1418).
[13] *Jeppsen*, 128 F.3d at 1419–20 (Kelly, J., dissenting).
[14] *Id.* at 1410.
[15] *Vincentini v. Commissioner*, 429 Fed. Appx. 560, 564 (6th Cir. 2011).
[16] The Court of Federal Claims has jurisdiction to render judgment upon any claim against the United States founded either upon the Constitution, or any Act of Congress of any regulation of an executive department, or upon any express or implied contract with the United States, or for liquidated or unliquidated damages in cases not sounding in tort. 28 U.S.C. § 1491(a)(1). The Federal Circuit has exclusive jurisdiction over appeals from the Court of Federal Claims. 28 U.S.C. § 1295(a)(3).
[17] I.R.C. § 7482(a)(1), (b); *see Golsen v. Commissioner*, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971).
[18] 28 U.S.C. §§ 1291, 1294, 1346.

PPP Loans and the Texas Franchise Tax

One of the many new terms introduced in 2020 was the Paycheck Protection Program (PPP). Established by the Coronavirus Aid, Relief, and Economic Security (CARES) Act (Pub.L. 116–136) and administered by the Small Business Administration (SBA), with the support of the United State Treasury, the PPP provides small businesses funds to pay up to eight weeks of payroll costs, including benefits, and allows for funds to be used to pay interest on mortgages, rent, and utilities. In January 8, 2021, legislation was enacted to expand the PPP to include a second draw loan for certain taxpayers and to expand the scope of eligibility for PPP funds.

One of the interesting and controversial aspects of the PPP is the loan forgiveness element. Originally, the IRS declared that business expenses incurred and paid for using forgiven PPP loans would be nondeductible, but revised its position in Rev. Rul. 2021-2, after the legislature in the Consolidated Appropriations Act of 2021 (Pub. L. No. 116-260) (CCA) specified that the forgiven loans would not be includible in income and ordinary, reasonable, necessary, business expenses associated therewith would not be disallowed. For Texans, this might create Texas franchise tax issues.

I. Introduction

The Texas Franchise Tax, based on a margin calculation, was originally made effective for 2008 franchise tax reports based on business conducted in 2007 and reported on the subject businesses' 2007 federal income tax returns, as set forth in Texas Tax Code § 171.1011. The margin calculation is based on a formula that subtracts cost of goods sold ("COGS"), compensation, or a standard / minimum deduction from the entity's revenues. The margin is then apportioned based upon a gross receipts formula, comparing gross receipts from business done in Texas to gross receipts form its entire business.

The franchise tax statute incorporates the Internal Revenue Code (IRC) 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 franchise tax.[1]

Both the CARES Act and the CAA state that the forgiveness of the PPP debt is not taxable income for federal tax purposes. However, both laws were enacted after January 1, 2007. Forgiveness of debt was generally taxable under the Internal Revenue Code effective January 1, 2007, as cancellation of indebtedness income. Therefore, unless an exception applied as of that date, forgiven PPP loans are likely to be includible in calculating both Texas franchise tax revenues and gross receipts.

As a general rule, when a debt is forgiven, or cancelled, a debtor's gross income includes an amount equal to the difference between what was due on the obligation and the amount the debtor has paid to date. The taxpayer realizes and recognizes a benefit equal to the value of the reduction of the liability. Since the debt was not included in income previously, a reduction of the debt becomes income when it's forgiven because it's a decrease in an existing obligation.

II. Revenues

The margin computation begins with a taxable entity's revenues. The franchise tax computation of revenue, which is used in calculating taxable margin, compiles amounts reported on specific lines of the applicable federal income tax forms for the various types of reporting entities.

---

[1] *See* Texas Tax Code § 171.0001(9).

Referencing specific lines on federal income tax forms allows Texas to incorporate, by reference, the entire body of federal tax law that determines the amounts reportable on the forms.

For PPP loan purposes, forgiven loans would need to be added back to the items reported on the federal income tax return in calculating Texas franchise tax revenues, unless the taxpayer identifies an exception from the inclusion that would have applied under the IRC in effect on January 1, 2007.

Unless there is some provision or reason forgiven loan receipts would not be treated as receipts for income tax purposes the Comptroller's office will require them to be receipts for franchise tax purposes.

III. Calculating Margin

How will the associated expenses fit into the equation? Taxpayers calculate margin by subtracting items from revenues. Margin is generally measured by revenues, less either COGS sold or compensation. COGS is calculated in accordance with instructions set forth in Texas Tax Code § 171.1012 as interpreted in Comptroller Rule 3.558. Compensation is calculated in accordance with instructions set forth in Texas Tax Code § 171.1013 as interpreted in Comptroller Rule 3.589. The other ways to compute margin aren't affected by the expenses deducted on the federal income tax return.

Businesses may use PPP loan funds to pay payroll costs, benefits, interest on mortgages, rent, and utilities. These costs may qualify for inclusion in computing COGS or compensation. To the extent they qualify under the Texas Tax Code and the Comptroller's Rules, it is anticipated the Comptroller's office will allow taxpayers to include offsetting expenses in COGS and compensation.

IV. Apportionment

The next question is how to apportion the gross receipts arising as cancellation of indebtedness income under the IRC of 2007.

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.[2] It is anticipated that the apportionment of receipts from forgiven loans would be apportioned based upon the location of payor rule and based upon the location of entity that is forgiving the loan.

Dividends and interest that are received from a national bank are apportioned to Texas if the bank's principal place of business is located in Texas. Dividends and interest that are received from a bank that is organized under the Texas Banking Code are apportioned to Texas. Therefore, loan forgiveness from national banks not headquartered in Texas may not be Texas gross receipts and may not be apportionable to Texas.

V. Potential Challenges

If a taxpayer can identify a particular IRC provision, Treasury Regulation, or other IRS guidance that loan forgiveness would not have been includible in income under the IRC of 2007, the taxpayer may have a valid challenge to inclusion of gross receipts in income.

Even though cancellation of indebtedness income is generally required to be reported on Form 1099-C if the proper conditions are met, the income is not necessarily required to be included in the recipient's income if the recipient meets certain exclusions. These exclusions might be considered as options for

[2] Tax Policy News, June 2010.

challenging inclusion in franchise tax gross receipts. For example, if a discharge of indebtedness occurs when the taxpayer is insolvent IRC §108(a)(1)(B) excludes it from gross income. IRC §108(a)(1)(A) excludes from gross income debt discharged in a "title 11 case" in a bankruptcy proceeding under title 11 of the United States Code (i.e., the Bankruptcy Code). To qualify, a taxpayer must be under the bankruptcy court's jurisdiction and the court must grant the discharge of indebtedness directly or pursuant to a plan approved by the court. IRC § 108(d)(2). The bankruptcy exclusion applies to all proceedings under title 11, including both chapter 7 liquidations and chapter 11 reorganizations. If a discharge of indebtedness occurs when the taxpayer is insolvent IRC §108(a)(1)(B) excludes it from gross income. Whether a taxpayer is insolvent is determined immediately before the discharge. Taxpayers can qualify to exclude cancelled debt from taxable income if (1) they incur debt directly in operating a farm, (2) more than half their income from the prior three years was from farming, and (3) the loan was owed to a person or agency regularly engaged in lending. There are other exceptions as well that might be considered; however, these may not all apply to PPP loan forgiveness, so taxpayers and practitioners should take caution in researching potential arguments against inclusion in franchise tax gross receipts.

The Texas Legislature convened for its 87th Regular Session on January 12, 2021. It could require a legislative change to make the corresponding adjustment to remove forgiven PPP loan proceeds from revenues and gross receipts and still allow the associated expenses to be included in COGS or compensation.

VI. Conclusion

Given the restrictions of the COVID-19 pandemic and the changed procedures applying to the legislative session, it is uncertain whether a legislative change would be prioritized. However, since it would benefit small businesses with forgiven PPP loans, it could be just the type of legislation Texas might want to pass during a pandemic. In the meantime, businesses and their advisors should plan for the potential inclusion of forgiven PPP in revenues and gross receipts, and ascertain whether the associated costs would be allowed for inclusion in COGS or compensation. Rep. Geren and Sen. Hancock have filed bills to exclude PPP loan forgiveness from franchise tax revenue calculations. *See* S.B. No. 372 and H.B. 1195. These will be ongoing issues as new batches of PPP loans are administered by the SBA in 2021.

CHRISTINA A. (CHRISTI) MONDRIK
is the founder of Mondrik & Associates, a tax law firm in Austin, Texas, where she and her associates represent taxpayers in state and federal tax controversies and litigation. She served as the State Bar of Texas Tax Section's Chair in 2019-20, and as the TXCPA Federal Tax Policy Committee Chair for the 2017-2019 term. Ms. Mondrik is an active member of the ABA Tax Section State and Local Tax Committee, a former chair of the Austin Chapter of CPAs, and a life fellow of the Texas Bar Foundation and the Travis County Women Lawyers' Foundation. She can be contacted at (512) 542-9300 or cmondrik@mondriklaw.com.

PRESENTED AT

68th Annual Taxation Conference

December 2-3, 2020
Live Webcast

Ethical Issues When Working Remotely (or did Alexa just waive privilege?)

Abbey B. Garber
Michelle M. Kwon

Authors Contact Information:
Abbey B. Garber
Thompson & Knight LLP
Dallas, Texas

Michelle M. Kwon
University of Tennessee
Knoxville, Tennessee

68th Annual Taxation Conference
Ethical Issues When Working Remotely (or did Alexa just waive privilege?)

A. INTRODUCTION

In a nationwide survey of lawyers conducted at the beginning of April, almost 90% of respondents reported that their offices were operating remotely in full or at least in part due to the COVID-19 pandemic.[1] By June, the percentage of firms surveyed who were working remotely in part or fully had dropped to 56%.[2] The 34% decrease in remote operations is likely the result, at least in part, of relaxed or expired state and local stay-at-home orders.[3] Despite this decrease, it is foreseeable that some number of lawyers will continue to work remotely, perhaps due to health concerns or to increasing responsibilities that ensued in the wake of the pandemic such as educating and caring for children and others at home. Even lawyers unburdened by those kinds of responsibilities might prefer to continue to work remotely due to the flexibility that remote working allows.[4] Many are predicting that the legal industry will continue to work remotely in some fashion even when the pandemic is over rather than reverting to the traditional brick-and-mortar practice of law.[5]

How does this "new normal" impact lawyers' ethical obligations to their clients? The easy answer is that the rules of professional conduct continue to apply despite the pandemic.[6] Nonetheless, it is worth reexamining several ethical duties that are implicated when practicing law remotely. This article considers the following ethical duties:

---

[1] Martin Cogburn, *How Law Firms are Responding to Covid-19-Remote Work*, https://www.mycase.com/blog/2020/04/survey-results-how-law-firms-are-responding-to-covid-19-remote-work/. The survey was conducted from April 8-10, 2020, and involved 819 respondents.

[2] Martin Cogburn, *How Law Firms are Adapting to New Normal of COVID-19 – State of Office and Challen*ges, https://www.mycase.com/blog/2020/07/new-survey-results-how-law-firms-are-adapting-to-new-normal-of-covid-19-state-of-office-challenges/.

[3] *Id*.

[4] *See*, *e.g*., *2019 Millennial Attorney Survey, New Expectations, Evolving Beliefs and Shifting Career Goals*, https://cdn2.hubspot.net/hubfs/209075/MLA_MillenialSurvey_040519_forWeb-1.pdf?__hstc=51254006.713226280951a037a37ce402169ad1bc.1604758029585.1604758029585.1604758029585.1&__hssc=51254006.1.1604758029585&__hsfp=176983327. This Above the Law survey of over 1,200 respondents indicates that 75% of millennial lawyers would prefer a more flexible work schedule to more pay.

[5] *See*, *e.g*., Law360, *New Normal of Legal Telework Likely to Outlast Pandemic* (July 24, 2020), https://www.law360.com/articles/1295207/new-normal-of-legal-telework-likely-to-outlast-pandemic; Bloomberg Law, *Analysis: The New Normal-Law Firms May Never be the Same* (May 7, 2020), https://news.bloomberglaw.com/bloomberg-law-analysis/analysis-the-new-normal-law-firms-may-never-be-the-same; David Lawson, *The Coronavirus Pandemic Could Mark the Dawn of the Virtual Office Revolution in the Legal Industry*, ABA Journal (Apr. 2, 2020), https://www.americanbar.org/groups/business_law/publications/blt/2020/04/virtual-office-revolution/.

[6] *See*, *e.g*., ABA Formal Opinion 482 (2018) (the rules of professional conduct continue to apply despite a natural disaster). Numerous state bars have issued ethics opinions and other guidance in response to COVID-19. *See*, *e.g*., PA Formal Opinion 2020-300, *Ethical Obligations for Lawyers Working Remotely* (Apr. 10, 2020), http://www.pabar.org/site/Portals/0/Ethics%20Opinions/Formal/F2020-300.pdf?ver=2020-04-21-111114-117; NYSBA, *Cybersecurity Alert: Tips for Working Securely While Working Remotely* (Mar. 12, 2020), https://nysba.org/app/uploads/2020/03/NYSBA-Cyber-Alert-031220.pdf.

- Competence and diligent representation (Rule 1.01)[7]
- Communication (Rule 1.03)
- Confidentiality (Rule 1.05)
- Remote supervision of junior lawyers and non-lawyers (Rules 5.01 and 5.03)

The discussion that follows may need to be tailored depending on the type and size of your law practice.[8] For example, large law firms presumably are better resourced as compared to solo practitioners and smaller firms, and thus, larger firms might be expected to implement more sophisticated security measures. There also may be special considerations for in-house legal departments and government lawyers. Moreover, the sensitivity of data that must be protected surely will vary depending on the type of practice. Also, keep in mind that a distinction should be made between what is minimally required to satisfy your ethical obligations as opposed to what are best practices.

B. Rule 1.01: Competent and Diligent Representation

It goes without saying that lawyers must possess the requisite legal knowledge, skill, and training to fulfill their ethical obligations to their clients. This obligation is expressed in Rule 1.01(a), which provides in relevant part that "A lawyer shall not accept or continue employment in a legal matter which the lawyer knows or should know is beyond the lawyer's competence."[9] When COVID-19 hit the United States and quickly began spreading, countless lawyers had to pivot their practices. For some, it was keeping up with evolving court and agency closures. For many others, the pandemic has undoubtedly uncovered novel legal issues in areas such as employment law and health law, as well as a host of contracts issues. Still other lawyers have had to study and investigate laws that have been enacted in response to COVID-19 such as the Payroll Protection Program and the economic impact payments made by the Treasury Department to individuals earlier this year.[10] The comments to Rule 1.01 make clear that lawyers can agree to a representation without having the requisite legal knowledge so long they can become competent through study and investigation.[11]

In 2019, the duty of competence applicable to Texas lawyers was expanded beyond substantive competence to include technological competence.[12] No disciplinary action may arise for being technologically incompetent because only the comments were

---

[7] Unless otherwise stated, references to Rules are to the Texas Disciplinary Rules of Professional Conduct.
[8] *See generally* ABA Cybersecurity Legal Task Force, The ABA Cybersecurity Handbook (2d ed. 2018) (discussing cybersecurity in the context of different legal practice settings, including large and small firms, in-house counsel, government lawyers, and public interest attorneys).
[9] "Competence" refers to the "possession of legal knowledge, skill, and training reasonably necessary for the representation." Rule 1.01, cmt. 1, referring to Terminology section in the Preamble to the Rules.
[10] Coronavirus Aid, Relief, and Economic Security Act, P.L. 116-136, 3/27/2020.
[11] Rule 1.01, cmt. 4.
[12] Rule 1.01, cmt. 8 (lawyers should "strive to become and remain proficient and competent in the practice of law, *including the benefits and risks associated with relevant technology*") (emphasis added). This 2019 change substantially follows a 2012 change to the ABA's Model Rule regarding competence, which provides: "To maintain the requisite knowledge and skill, a lawyer should keep abreast of changes in the law and its practice, *including the benefits and risks associated with relevant technology*." ABA Model Rule of Professional Conduct 1.1, cmt. 8 (emphasis added).

amended, as opposed to the competency rule itself.[13] Nonetheless, the practice of law in a remote environment is inextricably reliant on technology. It would be difficult to competently represent clients without the ability to navigate video conferencing platforms, to access email communications and documents remotely, to electronically file documents with courts, and to remotely appear for hearings. Ideally, lawyers would receive adequate training on new technologies being deployed. Ongoing support to navigate technological challenges would also be desirable, particularly for lawyers who are less technologically proficient. Additionally, it would be helpful to ensure that support staff are able to provide seamless service to attorneys even while they are physically separated, particularly for those lawyers who heavily relied on support staff while working in the brick-and-mortar office.

C. Rule 1.03: Communication

Rule 1.03(a) requires a lawyer to "keep a client reasonably informed about the status of a matter and promptly comply with reasonable requests for information." Furthermore, lawyers need to handle client matters with reasonable diligence and promptness.[14] Obvious issues that should be addressed to ensure prompt and effective communication with clients while working remotely include: (1) procedures for the intake and delivery of physical mail; (2) ensuring the prompt receipt of voicemails; (3) protocols for communicating with clients; and (4) tools for keeping abreast of deadlines.

Physical mail - Physical mail that is delivered to the brick-and-mortar law office should promptly either be physically delivered to addressees or scanned and electronically delivered.

Voicemail - To ensure lawyers promptly receive voicemails, one simple approach is to establish a policy that establishes the frequency with which lawyers are expected to remotely check their voicemails. Work-from-home frictions can be reduced by automating the process. One simple way is for lawyers to forward their work phones to another phone at their remote location. Alternatively, a law firm might have the functionality to send email notifications of voicemails or convert voicemails to audio files and send them by email. The recipient is then able to access voicemails from their email account and listen to voicemails by a simple click of the audio file.

Staying connected to clients – Clients should understand the best ways and times to get in touch with their attorneys. Thought should also be given to the best mode of communication given the nature of the relationship between the lawyer and client as well as the information being conveyed. For example, it might be more challenging to develop and maintain rapport in a virtual environment where cues such as body language that help us adjust our communication style are lacking. Particularly for prospective clients and new clients, communicating via video call to at least simulate an in-person meeting may be beneficial. If given the choice, even long-standing clients with whom you have an

---

[13] TRPC, Preamble: Scope ¶ 10.

[14] Rule 1.01(b)(1) ("In representing a client, a lawyer shall not neglect a legal matter entrusted to the lawyer.").

established rapport may prefer face-to-face communications, even if only in two dimensions on a screen, instead of conversations over text or email. Similarly, more face-to-face client contact might be desired in a family law or immigration law practice where emotions might run high, while clients with real estate or business matters might be less inclined to face-to-face interaction. The available information indicates that the majority of lawyers pivoted to video conferencing in response to COVID-19.[15] If employing videoconferencing, be sure to be familiar with the platform to minimize technical difficulties. When choosing the appropriate mode of communication, attention must be given to minimizing the risk of inadvertently disclosing client confidences or otherwise sensitive information. The issue of confidentiality is discussed further in the next section.

D. Rule 1.05: Client Confidentiality

Comprehensive data protection legislation is lacking at the federal level, and only a minority of states have wide-ranging data privacy laws.[16] Despite the lack of comprehensive data privacy laws, a patchwork of laws apply to particular industries. One relevant example is the Federal Trade Commission's Safeguards Rule, which requires tax return preparers to create and enact security plans to protect client data.[17]

In addition to statutory data privacy laws, lawyers have an ethical obligation—perhaps the most sacrosanct of all the ethical obligations—to safeguard confidential and privileged client information, including work product. This protection extends not only to information protected by the attorney-client privilege, but also to "all information relating to a client or furnished by the client . . . acquired by the lawyer during the . . . representation of the client."[18] Texas-licensed lawyers may be disciplined for "knowingly reveal[ing] confidential information of a client or a former client" to unauthorized persons.[19] The knowledge qualifier is not limited to actual knowledge. A lawyer's knowledge may also be "inferred from circumstances."[20]

There are at least three challenges in the virtual law office setting that implicate the duty of confidentiality. The first is cyberthreats due to the digital transmission and storage of client information. The second set of challenges relates to risks associated with employees' remote workspaces. The third is the risk associated with lawyers using their own personal devices to access firm email and networks.

---

[15] Celia Colista, *How Attorneys are Coping in the Pandemic* (June 9, 2020), https://www.martindale-avvo.com/blog/how-attorneys-are-coping-in-the-pandemic/ (80% of survey respondents deployed video conferencing after COVID-19 hit).

[16] *See* Sarah Rippy, *US State Comprehensive Privacy Law Comparison*, https://iapp.org/resources/article/state-comparison-table/ (as of October 14, 2020, only California, Maine, and Nevada have comprehensive privacy laws). Section 521.052 of the Texas Business and Commerce Code requires businesses to "implement and maintain reasonable procedures" to protect the disclosure of "sensitive personal information," which includes social security numbers and financial account information.

[17] *See* IRS Publication 4557, Safeguarding Taxpayer Data.

[18] Rule 1.05(a).

[19] Rule 1.05(b)(1).

[20] TRPC, Terminology.

1. Cyberthreats and Confidentiality

Law firms are attractive to cyberthieves for two reasons. First, law firms maintain what cyberthieves see as lucrative client data, such as intellectual property, trade secrets, financial data, and business and litigation strategies.[21] Consider the following examples:

- Three individuals were indicted in 2016 for insider trader for allegedly stealing confidential information from prominent international law firms engaged in corporate mergers and acquisitions.[22]
- Seyfarth Shaw LLP was the subject of a ransomware attack in October 2020.[23]
- Earlier this year, a New York City entertainment law firm whose clients include numerous high-profile celebrities became the target of a ransomware attack. After the firm rebuffed a $21 million ransom demand, the attackers leaked stolen data about Lady Gaga, one of the firm's clients.[24]
- Perhaps the most well-known law firm hack was of the former Panama-based law firm Mossack Fonseca in 2016.[25] The hack resulted in the leak of the so-called Panama Papers, which resulted in the disclosure of confidential information of "hundreds of thousands of individuals and entities."[26] Mossack Fonseca's outdated technology and lax computer security likely contributed to the hack.[27]
- Closer to home, several Texas firms and national firms with Texas offices were reportedly being targeted by hackers back in 2016.[28]

[21] *See* Nathan Powell, *Electronic Ethics: Lawyers' Ethical Obligations in a Cyber Practice*, 29 GEORGETOWN J. LEG. ETHICS 1237, 1238 (2016). *See also Large Law Firms' Secret Information From Big-Money Clients Entice Cyberthieves*, ABA J. (Jan. 2018), https://www.abajournal.com/magazine/article/large_law_firms_cybertheft_risk/P1

[22] U.S. ATTORNEY'S OFFICE FOR THE SOUTHERN DISTRICT OF NEW YORK PRESS RELEASE, *Manhattan U.S. Attorney Announces Arrest of Macau Resident and Unsealing of Charges Against Three Individuals For Insider Trading Based on Information Hacked From Prominent U.S. Law Firms* (Dec. 27, 2016), https://www.justice.gov/usao-sdny/pr/manhattan-us-attorney-announces-arrest-macau-resident-and-unsealing-charges-against.

[23] Xiumei Dong, *Seyfarth Cyberattack Spotlights Gaps in Law Firm Security*, Law360 (Oct. 15, 2020), https://www.law360.com/articles/1319407/seyfarth-cyberattack-spotlights-gaps-in-law-firm-security.

[24] Kathryn Rubino, *Lady Gaga Documents Leaked After Law Firm Was Hacked*, Above the Law (May 18, 2020), https://abovethelaw.com/2020/05/lady-gaga-documents-leaked-after-law-firm-was-hacked/.

[25] *See*, *e.g.*, Luke Harding, *What are the Panama Papers? A Guide to History's Biggest Data Le*ak, The Guardian (Apr. 5, 2016), https://www.theguardian.com/news/2016/apr/03/what-you-need-to-know-about-the-panama-papers. Mossack Fonseca ceased its operations in 2018. Jaclyn Jaeger, *Mossack Fonseca Closing its Doors*, Compliance Week (Mar. 19, 2018), https://www.complianceweek.com/mossack-fonseca-closing-its-doors/8635.article.

[26] Victor L. Hou et al., *Cleary Gottlieb Discusses U.S. Criminal Prosecutions Based on Panama Papers Hack*, The CLS Blue Sky Blog (Jan. 29, 2019), https://clsbluesky.law.columbia.edu/2019/01/29/cleary-gottlieb-discusses-u-s-criminal-prosecutions-based-on-panama-papers-hack/.

[27] *See* James Temperton and Matt Burgess, *The Security Flaws at the Heart of the Panama Papers*, Wired (Apr. 6, 2016), https://www.wired.co.uk/article/panama-papers-mossack-fonseca-website-security-problems. One expert described the law firm as "caught in a time warp."

[28] John G. Browning, *Why Cybercriminals are Targeting Law Firms*, D Magazine (Aug. 2016), https://www.dmagazine.com/publications/d-ceo/2016/july-august/cybercrime-targets-law-firms/.

These examples barely scratch the surface. ABA survey data from 2018 estimates that about one of every four firms has experienced a data security breach.[29] The risk seems to be somewhat correlated to firm size. In particular, 14% of solo practitioners reported a breach as compared to 42% of firms with 50-99 lawyers and 31% of firms with 100 or more lawyers.[30] In 2020, the number of firms who experienced a data security breach increased to about one in every three firms.[31]

Beyond the valuable information that law firms possess, the second reason that law firms are attractive to cyberthieves is because hackers perceive law firms to be easy targets. The legal industry generally does not have a reputation for being technologically savvy.[32] A cyber security expert paints this picture: "Look at the back seat of the car of the average partner's BMW and I think you'd be quite shocked. These guys still take large bundles of papers around tied up with ribbons."[33] Objectively, there is some truth in this observation.

Failing to prioritize cybersecurity is risky given the work-from-home environment. "Nearly ubiquitous connectivity generates nearly ubiquitous vulnerability." Although this quote comes from a 2011 law review article, it aptly describes the state of affairs in the remote work environment brought on by the pandemic.[34] The rise in the number of employees working from home creates more opportunities for hackers to attack. One telling data point to consider: a leading cyber insurer reported that the frequency of ransomware attacks rose 260% in the first six months of 2020.[35] Given the increased vulnerability, it is imperative for law firms to take reasonable efforts to protect confidential information.[36]

Despite the obvious risk of cyber attack and the ethical obligations to protect client information, firms remain vulnerable. The ABA surveyed attorneys in private practice in law firms of all sizes between March and May of 2020—*i.e.*, while the country was in the early stages of dealing with the pandemic.[37] The following chart shows the percentage of survey respondents who have adopted each of the technologies:

Technology	Percentage of users
File encryption	43%

[29] David G. Ries, *2018 Cybersecurity*, ABA TechReport 2018 (Jan. 28, 2019), https://www.americanbar.org/groups/law_practice/publications/techreport/ABATECHREPORT2018/2018Cybersecurity/.
[30] *Id*.
[31] John G. Loughnane, 2020 Cybersecurity, ABA TechReport 2020 (Oct. 19, 2020), https://www.americanbar.org/groups/law_practice/publications/techreport/2020/cybersecurity/.
[32] *See e.g.*, Frank Ready, *Businesses Want Outside Counsel to be More Tech Savvy. What Does That Mean?*, NY L. J. (July 14, 2020) ("It's no secret that law firms in general remain behind the curve when it comes to incorporating new technology into their services.").
[33] *See* Temperton & Burgess, *supra* note 27 (quoting Dr. Daniel Dresner).
[34] Roland L. Trope & Sarah Jayne Hughes, *Red Skies in the Morning – Professional Ethics at the Dawn of Cloud Computing*, 38 WM. MITCHELL L. REV. 111, 118 (2011).
[35] Dong, *supra* note 23.
[36] *See* Texas Ethics Op. No. 648 ("Since a 'knowing' disclosure can be based on actual knowledge or can be inferred, each lawyer must decide whether he or she has a reasonable expectation that the confidential character of the information will be maintained if the lawyer transmits the information by email.").
[37] Loughnane, *supra* note 31.

Email encryption	39%
Two-factor authentication	39%
Intrusion prevention	29%
Intrusion detection	29%
Remote device management and wiping	28%
Device recovery	27%
Web filtering	26%
Employee monitoring	23%
Biometric login	12%

Even before the pandemic struck the U.S. at the beginning of this year, the Professional Ethics Committee of the Texas State Bar had addressed the use of technology to transmit and store confidential information. Texas Ethics Opinion 648 (Apr. 2015) made clear that lawyers generally may use unencrypted email to communicate confidential information while also recognizing that the circumstances may justify communicating by other means. Texas Ethics Opinion 665 (Dec. 2016) discussed lawyers' role in mitigating and preventing the inadvertent transmission of metadata.[38] More recently, Texas Ethics Opinion 680 (Sept. 2018) concluded that lawyers may store confidential information and other data on the cloud if reasonable precautions are followed.[39]

To better protect confidential client information, the ABA, in its 2020 TechReport[40] recommends the following actions:

- Strengthen passwords
- Enable multi-factor authentication
- Fortify your network
- Secure your network administrator
- Enforce wi-fi authentication
- Limit guest access
- Protect internet systems[41]

---

[38] In simple terms, metadata is data that is automatically created by computers and embedded into computer-generated documents.
[39] Texas Ethics Opinion No. 680 (Sept. 2018). The cloud is a virtual storage space on the internet that allows employees, without regard to their physical location, to access digital resources like documents.
[40] Bryan Lieber, Law Firm Guide to Cybersecurity (Oct. 22, 2020).
[41] Individuals should review their own personal router settings to take the following steps to protect clients' information: (1) Make sure you have changed the device's default administrative (internal) password to one that is unique to you *and* (2) set a strong unique WiFi password (phrases are good) of 15 characters. (3) Change the name of the WiFi network (its SSID)—if you use the manufacturer's default you have effectively established your network as if it were public WiFi). In addition, (4) make sure that the router is using the latest encryption standard (preferably WPA2). (You should be able to find the various manufacturer settings by going to the manufacturer's website.) Anthony E. Davis and Janis M. Meyer, Rising to the Ethical Challenges of Remote Working, New York Law Journal (May 01, 2020), https://www.law.com/newyorklawjournal/2020/05/01/rising-to-the-ethical-challenges-of-remote-working/

The adage that "the best defense is a good offense" seems fitting during these pandemic times. Importantly though, the ethical duty of confidentiality does not require a foolproof system to prevent the unauthorized disclosure of confidential client information.[42] Eliminating all cybersecurity risks might not be possible, and in any event, is not practical. What is required is that lawyers undertake reasonable efforts in light of the circumstances.[43] An audit of the current technology might be warranted to determine whether existing data security efforts are reasonable in light of the now ubiquitous work-from-home environment.[44] Consideration should be given to the transmission and storage of sensitive client information such as financial information, social security numbers, bank account information, confidential deal information, and litigation strategies. Because technology is constantly evolving, lawyers must continuously reassess the risks associated with the technologies relied on.

2. Risk of Inadvertent Disclosures Due to Working From Home

As discussed in the last section, technology can help manage the risk of data breaches. But "frequently the weakest link in the security of a law firm is its personnel."[45] This section describes some of the steps that can be taken to manage the risk of data breaches due to working from home.

There is no friends-and-family exception to a lawyer's duty of confidentiality. This maxim was true in a bricks-and-mortar law practice and remains true in the virtual law office environment. Thus, lawyers have always had to resist the temptation to gossip about their clients. The difference now is that the risk of inadvertent disclosure of client information potentially is greater when lawyers are sharing a home workspace. The threat of this risk looms large because attorney-client privilege may be destroyed when otherwise confidential communications take place in the presence of a third party.[46] As noted above, even if the information is not subject to the attorney-client privilege, Rule 1.05 covers "all information . . . acquired by the lawyer during the course of or by reason of the representation of the client."[47]

Remote workspaces should be designed to minimize the inadvertent disclosure of client confidences to unauthorized persons such as members of the lawyer's household,

[42] *See* ABA Model Rule 1.6(c), cmt. 18 ("Factors to be considered in determining the reasonableness of the lawyer's efforts include . . . the likelihood of disclosure if additional safeguards are not employed, the cost of employing additional safeguards, the difficulty of implementing the safeguards, and the extent to which the safeguards adversely affect the lawyer's ability to represent clients").
[43] *See* Rule 1.05(a) ("knowing" violations of confidentiality rule are prohibited) and TRPC, Terminology (defining "knowing" to include inferred knowledge). *See also* ABA Model Rule 1.6(c) ("A lawyer shall make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client."). See also ABA Opinion 477R (2017).
[44] *See* Texas Ethics Opinion Rule No. 648 (acknowledging that an evaluation of "email technology and practices should be ongoing as there may be changes in the risk of interception of email communications over time that would indicate that certain or perhaps all communications should be sent by other means.").
[45] Steven M. Puiszis, *Can't Live With them, Can't Live Without Them: Ethical and Risk Management Issues for Law Firms that Adopt a "BYOD" Approach to Mobile Technology*, 2015 PROF. LAW. 33, 38 (2015).
[46] *See* Tex. R. Evid. 503; *In re Small*, 346 S.W.3d 657, 663 (Tex. Ct. App. 2009).
[47] Rule 1.05(a).

household staff, and guests. Lawyers should not carry on telephone or video calls within earshot of such persons. The use of headsets can also help to prevent others from hearing those conversations.

Some commentators suggest not recording or allowing others to record video calls.[48] The caution against recording is to prevent the intentional or inadvertent distribution of the digital file. As aptly stated at a recent State Bar Texas CLE, "lawyers should be very wary of recording any attorney-client conversation because you risk the exposure of privileged information."[49] Also, consider whether any benefits of sharing documents over video conferencing platforms such as Zoom outweigh any potential risks. To maintain control over such things as the ability to record or share screens, lawyers should insist on hosting video calls.[50]

Commentators recommend turning off or muting Alexa, Echo, and similar digital virtual assistants.[51] These devices are standing by ready to record your voice commands and the companies providing these services collect and digitally store that data.[52] There have also been reports of these devices inadvertently recording conversations.[53] Confidentiality concerns arise if an unauthorized person obtains access to client information recorded in that manner. There have also been instances where this kind of data stored from internet-connected devices might be obtained in connection with an investigation of some kind or used as evidence in court.[54]

Attention should also be given to the physical workspace. Ideally, the lawyer should have a separate physical working space that can be locked. If this is not possible, be careful to restrict access to computers and other digital devices with strong passwords and secure any physical files and documents. Employees should also understand how to properly dispose of physical documents containing confidential information.

Given the portability of our work, caution must be exercised when lawyers are working in public places such as coffee shops within earshot or eyeshot of others. Moreover, refrain from using public Wi-Fi because in most cases public Wi-Fi is not secure.[55] Joining the internet using the coffee shop's network is more secure if you use a virtual private network

---

[48] Nichole Bunker-Henderson and Cole Hutchison, Mark, Will you Keep my Client's Secret?, State Bar of Texas 32nd Annual TXCLE Advanced Admin. L. (2020).
[49] *Id*.
[50] *Id*.
[51] *See*, *e.g.*, Crystal Tse and Jonathan Browning, *Locked-Down Lawyers Warned Alexa is Hearing Confidential Calls*, Bloomberg (Mar. 20, 2020), https://www.bloomberg.com/news/articles/2020-03-20/locked-down-lawyers-warned-alexa-is-hearing-confidential-calls
[52] Geoffrey A. Fowler, *Alexa Has Been Eavesdropping on You This Whole Time*, Wash. Post (May 6, 2019), https://www.washingtonpost.com/technology/2019/05/06/alexa-has-been-eavesdropping-you-this-whole-time/.
[53] *See id*.
[54] Haley Sweetland Edwards, *Alexa Takes the Stand: Listening Devices Raise Privacy Issues*, Time (May 4, 2017).
[55] FED'L TRADE. COMM'N, *Tips for Using Public Wi-Fi Networks*, https://www.consumer.ftc.gov/articles/0014-tips-using-public-wi-fi-networks.

(VPN).[56] A VPN adds security to a public Wi-Fi by encrypting data moving between your computer and the internet.[57]

Finally, anyone with access to confidential information should receive training on relevant data security policies and procedures and the importance of data security and client confidentiality should consistently be emphasized. Even with state-of-the-art technology, threats exists due to human error.[58]

3. Bring Your Own Device (BYOD) Risks

BYOD refers to employees' use of their own personal devices to access the firm's computer network, including the email system, documents, and other work product.[59] Twenty years ago, it was common for law firms to dole out firm-owned BlackBerrys.[60] In recent years, it has become more common for lawyers to use their personal phones to access work emails and their own tablets, laptops, or home computers to access the firm's network.[61] BYOD offers several advantages. First, law firms save money by not having to provide every lawyer one or more of these devices.[62] Firms also benefit from the potential for greater productivity of lawyers who have the flexibility to work from anywhere at any time.[63] Employees also benefit by not having to carry around and manage multiple devices. Moreover, the flexibility afforded to employees to work from anywhere perhaps leads to greater job satisfaction and better employee morale.

However, the benefits of BYOD are not risk-free. When employees work on client matters using firm-owned devices, the firm can ensure that the devices have the necessary tools to minimize the risk of cyberthreats. Firms can require strong passwords. Devices can be set to lock after a period of inactivity. Software can be used to help to protect data from hackers. Firms can prescribe the kinds of software and applications that can and cannot be used on firm-owned devices. But by allowing employees to use their own devices, firms forego some of that control, which opens the door to increased cybersecurity threats.[64] An unsecured or under-secured personal device can serve as a cyberthief's

---

[56] *Id*.
[57] *Id*.
[58] ABA CYBERSECURITY HANDBOOK 274, *supra* note 8 ("Countless studies, audit trails, and surveys over the years have repeatedly confirmed that the biggest data protection threats come from within one's own organization.").
[59] Puiszis, *supra* note 45, at 33.
[60] Anonymous Partner, *Biglaw's BlackBerry Bye-Bye*, ABOVE THE LAW (Sept. 10, 2013), https://abovethelaw.com/2013/09/biglaws-blackberry-bye-bye/.
[61] The Sedona Conference Data Privacy Primer, 19 SEDONA CONF. J. 273, 425 (2018).
[62] *See id*.
[63] *See id*. A survey in March 2020 indicated that 63% of employers worried about a decline in worker productivity due to remote working. By June, that concern decreased decreased significantly to 26%. *PwC US CFO Pulse Survey* (June 15, 2020), https://www.pwc.com/us/en/library/covid-19/pwc-covid-19-cfo-pulse-survey.html#challenges. See also Andrew Maloney, *COVID-19 is Driving Long-Term Changes in Big Law for Remote Work, Fees, Hi*ring (Oct. 5, 2020), https://www.law.com/americanlawyer/2020/10/05/covid-19-is-driving-long-term-changes-in-big-law-for-remote-work-fees-hiring/ (reporting that the Seattle office of Davis Wright Tremaine's client service levels post-COVID are comparable to pre-COVID levels of productivity).
[64] *See*, *e.g.*, Puiszis, *supra* note 45, at 34 ("Owners of BYOD devices frequently download software they prefer to use when working remotely and applications for their personal use during off hours. Thus, BYOD

entry point to the firm's computer network. Additional risks are generated if employees download sensitive or confidential information onto their unsecured or under-secured personal devices or their otherwise adequately secured personal device that is lost or stolen. There are also risks if an employee stores client data using an unapproved cloud service such as Dropbox.

The safest bet is to prohibit the use of employee-owned devices. But to the extent that the proverbial horse is out of the barn, a complete ban is no longer practical. If you decide to permit personal devices to access firm or client data, it might be beneficial for employees to identify devices that employees are working on from home. Some firms might find it desirable to limit the kinds of devices that may be used for firm business.

Firms that permit personal devices to access firm or client data should have a BYOD policy.[65] Such a policy, assuming it is understood by employees and enforced, can give firms the ability to exercise control over non-firm owned devices that will interface with the firm's computer network or email system. A BYOD policy could include provisions such as: password requirements, the requirement for the device to automatically lock after a period of inactivity, restricting use by others of any personal device to be used for firm business, the requirement for the device to be locked remotely if it is lost or stolen, and mandated encryption and antivirus software. The policy could also prohibit employees from storing any firm or client information to a non-approved cloud or to their personal devices. Mobile device management software can be used to implement and manage these tasks.

A BYOD policy should also describe what happens to firm-owned or client-owned data on personally owned devices when employment is terminated.[66] Firms could obtain employees' consent to submit their personal devices to the firm to allow any such data to be identified and removed. It is also possible to remotely erase data from a device, oftentimes using software that is already on the device. In some cases, it may be possible to wipe only work accounts instead of all data. For example, if an employee has both a personal Google account and a work account, the employer might be able to delete only the data associated with the work account.

These kinds of BYOD policies create a tension with an employee's expectations of privacy. After all, the devices we are talking about are owned by the employee, not the firm. How much access should an employer have to employees' personally owned devices to enforce the firm's BYOD policy? To what extent should an employer be able to access employees' personal information on their personally owned devices and for what purpose? Monitoring employees' personally owned devices and removing data from them might

---

inevitably brings with it BYOS ('Bring Your Own Software') and BYOA ('Bring Your Own Applications') because of their popularity and ease of use. Frequently, this software is cloud-based, which means BYOD often also frequently results in BYOC ('Bring Your Own Cloud').").

[65] Sample BYOD policies are included in Puiszis's article (see *supra* note 45) and Powell's article, which is cited in *supra* note 21.

[66] Relatedly, procedures should exist to retrieve firm-owned devices and physical files and other property from employees when employment ceases. In cases of involuntary termination, it might make sense to get the devices prior to termination.

implicate privacy protection laws such as the Electronic Communications Privacy Act (ECPA) and the Stored Communications Act (SCA).[67] In the interest of simplicity, the ECPA protects electronic communications while in transit while the SCA protects stored electronic communications.[68] But liability can be avoided by obtaining the employee's prior consent.[69]

E. Rules 5.01 and 5.03: Remote supervision of junior lawyers and nonlawyers

Partners in law firms and those having direct supervisory authority over lawyers should take steps to ensure the quality of the legal advice that junior lawyers provide and the work product that junior lawyers produce.[70] Moreover, supervising lawyers should ensure that junior lawyers comply with the rules of professional conduct. Supervising lawyers also need to ensure that nonlawyers, such as legal assistants and secretarial staff, conduct themselves in a manner that is consistent with the rules of professional conduct.[71] Failing to appropriately supervise junior lawyers and nonlawyers could subject the supervising lawyer to discipline pursuant to Rules 5.01 and 5.03 of the Texas Disciplinary Rules of Professional Conduct.

Supervision and career development can be challenging when people do not share the same physical location. But there are steps that can be taken to ease some of the challenges. First, lawyers should be reminded that the pandemic does not relieve them from their ethical obligations. Second, supervising lawyers should become familiar with tools that are designed to enable communication. Popular examples include Slack and Microsoft Teams. Thoughtful consideration should be given to the right communication tool given what needs to be accomplished. Is an asynchronous mode such as an email or memo appropriate or would a synchronous mode such as a phone or video call better? For example, an email, chat, or text probably works fine for simple requests or tasks. A phone call can often be used to help clarify something or to clear up a misunderstanding. Complex matters though might justify a video call where the participants can see one another and documents or slides or a whiteboard can be shared remotely. Emotional or sensitive issues might also justify a synchronous mode of communication such as a video call.

---

[67] 18 U.S.C. § 2509 et. seq. (ECPA) and 18 U.S.C. § 2701-2711 (SCA). The federal district court for the southern district of Texas held that an employer had no liability under the ECPA after it remotely wiped all data from a former employee's iPhone—both company-owned and personal. *Rajaee v. Design Tech Homes, Ltd.*, No. H-13-2517, 2014 WL 5878477 (2014). The ex-employee used his iPhone to access his work calendar and emails. The court found that the statute was not intended to cover this kind of a circumstance. Even if courts might be narrowly interpreting these federal data protection statutes, employers would be wise to fully explain to employees the risks involved with remote wiping of devices.

[68] Michael Kelsheimer and Travis Crabtree, *Privacy Rights of Employees in an Electronic World*, 56 The Advoc. (Texas) 60, 63 (2011).

[69] *Id*. at 61-64.

[70] Rule 5.01. A partner or supervising lawyer is subject to discipline under Rule 5.01 if that person orders or knowingly permits a junior lawyer to violate the ethical rules or that person, knowing that a junior lawyer has violated the rules, fails to take remedial action.

[71] Rule 5.03(a). Lawyers can also be subject to discipline for ordering or encouraging nonlawyers to engage in conduct that would violate the ethical rules if the person were a lawyer or for failing to take remedial action after a knowing violation. Rule 5.03.

Expectations regarding deadlines, billable hours, work schedules, and similar matters should be clearly communicated. An important consideration is instituting ways to replicate office drop-ins among lawyers, particularly to give less experienced lawyers avenues to ask questions of, and seek advice from, more senior lawyers. Unique issues generated as a result of the pandemic should also be addressed. For example, do at-home distractions justify reducing billable hour loads? What impact does the pandemic have for lawyers on the partnership track? What support, financial and otherwise, will be provided to lawyers who become ill or become caretakers for someone who is ill?

Finally, the emotional toll of COVID-19 has been the subject of several recent studies.[72] Those studies document increased levels of stress, anxiety, burnout, and substance abuse.[73] Law firm partners and management should be sensitive to lawyers' emotional well-being. Not only is this the humane thing to do, but mental wellness could implicate a lawyer's competence and ability to provide effective representation. In addition to check-ins with colleagues, law firms should communicate to lawyers available mental health resources, such as employee assistance programs and mental health care.

[72] Rhitu Chatterjee, *Pandemic's Emotional Hammer Hits Hard*, NPR (Sept. 2, 2020).
[73] *Id*.

CARING ABOUT CHARITABLE GIVING:

THE CARES ACT IN 2021

The Coronavirus Aid, Relief and Economic Security (CARES) Act, passed on March 27, 2020 provided much needed economic assistance to Americans for the 2020 year. Some of those benefits intended to encourage charitable giving have been extended to apply for 2021, via the Consolidated Appropriations Act signed into law on December 27, 2020; the purpose of this article is to provide a brief overview of those charitable giving incentives and other impacts this extension has on the exempt organizations landscape.

1. Above the Line Deduction

What's new: The 2021 extension slightly modifies the 2020 CARES Act above-the-line deduction granted to non-itemizers. For the 2021 year, gifts of cash to a public charity entitle an individual of up to $300 in an above the line income tax charitable deduction.[1] For a married couple filing jointly, the limit is $600 in cash gifts made to public charity. Under the 2020 version, the limit was $300 per tax return, so this change has allowed married couples filing jointly to effectively take double the deduction.[2] This above the line deduction appears to be permanent, as the language in the 2021 Act begins "[i]n the case of any taxable year beginning in 2021…".[3]

Taxpayers who overstate their cash contributions when claiming this deduction are now subject to a harsher penalty: If the IRS determines the value of the charitable gift has been overstated (and thus, the tax liability underpaid), the taxpayer can be assessed a penalty of 50% of the total deduction amount, an increase from 20% under prior law.[4]

Why it matters: This provision means a taxpayer can claim this ($300 or $600) amount as a deduction without having to itemize deductions. Under the Tax Cut and Jobs Act of 2017 (the "2017 Tax Act"), the standard deduction was increased, and as a result, much fewer people are itemizing their deductions, including those for gifts made to charity.[5] This deduction provides those who don't itemize an extra bump: you can take the standard deduction and give $300 (or $600 if married, filing jointly) to charity, and take the $300 or $600 tax break in addition to your standard deduction. This also helps because it reduces the donor's adjusted gross income, potentially allowing the taxpayer to then qualify for other tax breaks.[6]

Proceed with caution: Note that gifts to supporting organizations, donor advised funds and private foundations do not qualify for this deduction. The gift must be of cash – including those made by

---

1 P.L. 116-260, Consolidated Appropriations Act, 2021.

2 Ashlea Ebeling, "New Bigger Charitable Tax Break for 2021 in Year-End Spending Package", Forbes, https://www.forbes.com/sites/ashleaebeling/2020/12/22/new-bigger-charitable-tax-break-for-2021-in-year-end-spending-package/?sh=3e35e5c85710.

3 P.L. 116-260, Consolidated Appropriations Act, 2021.

4 *Id.;* Ashlea Ebeling, note 2.

5 According to the IRS, almost 9 out of 10 taxpayers choose not to itemize their deductions, choosing instead to take the standard deduction. https://www.irs.gov/newsroom/special-300-tax-deduction-helps-most-people-give-to-charity-this-year-even-if-they-dont-itemize

6 *See* note 2.

check, credit card, debit card or electronic fund transfer, but not securities, household items or other property.[7]

This benefit is not available for those individuals who itemize, rather, it is a benefit provided exclusively to those who claim the standard deduction. Further, no carryover is applied, meaning, it does not include any carryover of excess charitable contributions from previous years.[8] Likewise, any amount exceeding the $300 (or $600) limit can not be carried forward to future years or claimed as an itemized deduction.[9]

As with all charitable contributions, remember to obtain and maintain the proper forms of substantiation for all charitable gifts, particularly when they are at least $250 in amount.

2. For Those Who Itemize

We know that for charitable gifts made during lifetime, the actual amount of the deduction taken doesn't necessarily match the amount of the gift made, due to the various limitations based on the taxpayer donor's adjusted gross income ("AGI"), the type of property gifted and the type of charitable donee. A full chart of the application of AGI limits is included at the end of this article for reference. For those who itemize their deductions, the 2017 Tax Act increased the limit for gifts of cash made to public charities and private operating foundations from 50% of AGI to 60% of AGI, until January 1, 2026 (or until other legislation is enacted), with any excess carried over for up to the succeeding five years.

For years 2020 and 2021, this 60% AGI limit is increased to a 100% AGI limit, with any excess subject to the same 5-year carryforward rule (which would then be subject to the 60% AGI limit). This 100% AGI provision must be elected into – thus, there are some planning opportunities available if the value of the deduction would be more beneficial in a future year.[10]

Proceed with caution: This provision does not apply to gifts made to supporting organizations, donor advised funds ("DAF") or private non-operating foundations. Congress intended this law to increase charitable giving in this time of great need, and for the funds to have an immediate impact. Thus, the rule is not available for charitable gifts to organizations which facilitate deferred charitable spending (such as a DAF).[11] Although there is not much in the way of guidance, it is unlikely this 100% AGI limit would apply to a charitable remainder trust and it is unclear if it would apply to a gift of cash to a public charity in exchange for a charitable gift annuity.[12]

---

[7] IRS Publication 526, Charitable Contributions; https://www.irs.gov/newsroom/special-300-tax-deduction-helps-most-people-give-to-charity-this-year-even-if-they-dont-itemize

[8] Abbey M. Magnuson & Jason J. Kohout, "CARES Act Changes to the Charitable Income Tax Deduction", https://www.foley.com/en/insights/publications/2020/05/cares-act-changes-charitable-income-tax-deduction.

[9] John McKinley, "The new charitable deduction for nonitemizers", Journal of Accountancy, September 1, 2020, https://www.journalofaccountancy.com/issues/2020/sep/cares-act-charitable-deduction-for-nonitemizers.html.

[10] Abbey M. Magnuson, note 8.

[11] Bernie Kent, "Giving More Than 60% of Income to Charity? CARES Act Says Deduct It!", Forbes, https://www.forbes.com/sites/berniekent/2020/04/03/giving-more-than-60-of-income-to-charity-cares-act-says-deduct-it/?sh=657b37e8b34f.

[12] Abbey M. Magnuson, note 8.

Stacking: This limit can be stacked with the other AGI limits we are used to applying. For example, a donor can contribute long term capital gain property to a public charity, subject to a deduction of 30% of his AGI, and can additionally make a cash gift (to a qualified public charity) of 70% of his AGI, receiving a full 100% AGI deduction.

Although this 100% AGI limit doesn't apply to DAF gifts, because stacking is allowed, donors who exhaust the 60% AGI limit with cash contributions to their DAFs in 2021 can make additional (cash) donations outside their DAF (to a qualified public charity) and still get take the deduction this year, up to the 100% AGI limit.[13]

Planning Opportunities: Depending on the donor's tax situation, he/she may want to consider bunching charitable contributions in the same year, to take advantage of this higher AGI limit. Similarly, taxpayers with a zero-ed out estate and with no concern over having an estate tax liability at death, may want to accelerate their charitable gifts to occur during lifetime to get these income tax benefits.

On the other hand, it is possible that a 100% AGI limit is not the most advantageous strategy for a donor and his/her tax situation. The 100% AGI limit is an election that is made with respect to each gift, on the individual's income tax return. Failure to make the election would convert the cash contribution to the 60% AGI limitation, with the excess to be carried forward for the next five years, rather than utilized completely in 2021. If the donor has other itemized deductions, for example expenses resulting in a net operating loss that cannot be carried forward or back to other years, a charitable contribution of 100% of AGI may not receive a full tax benefit.[14] Thus, it may be more advantageous to limit qualifying charitable contributions to the donor's taxable income after all itemized deductions are taken into account – i.e. not electing the 100% AGI limit for (all of) his cash gifts made to qualified public charities.

3. Relief for Nonprofit Organizations

Nonprofit organizations with less than 500 employees may be eligible for loans under the second installment of the Paycheck Protection Program ("PPP"). The program is open to nonprofit organizations who previously received PPP support as well as those that have not, although additional requirements and limits apply to those organizations who have received previous PPP support. The Consolidated Appropriations Act expanded PPP eligibility to include 501(c)(6) organizations and destination marketing organizations. If you have a client who may be eligible, it is worth looking into these provisions.[15] The Consolidated Appropriations Act also includes targeted relief (in the form of grants) to "shuttered venues," including museums, theaters, and performing arts organization.[16] An organization that obtains a PPP loan is not eligible for a shuttered venue grant. An organization that qualifies for both programs should carefully consider which program is the better fit for its needs.

---

[13] https://www.vanguardcharitable.org/news/how-the-cares-act-affects-your-giving#:~:text=This%20means%20that%20Vanguard%20Charitable,reaching%20the%20100%25%20limit.

[14] Bernie Kent, note 11.

[15] See: https://www.sba.gov/funding-programs/loans/coronavirus-relief-options/paycheck-protection-program.

[16] P.L. 116-260, Consolidated Appropriations Act Sec. 324 et seq.

	Donee: Public Charity or Private Operating Foundation		Donee: Private Non-operating Foundation	
Property	Value of Deduction	Deduction limit as % of AGI	Value of Deduction	Deduction limit as % of AGI
Cash	Amount of cash	Can elect 100% if to PC; 60% to SO or DAF	Amount of cash	30%
Ordinary income	Cost Basis	50%	Cost Basis	30%
S/T Capital Gain Property ("CG")	Cost Basis	50%	Cost Basis	30%
L/T CG (other than TPP)	FMV	30%*	Qualified appreciated stock: FMV	20%
L/T CG/TPP (related use)	FMV**	30%	All other LTCG: Cost Basis	20%

*Donor can elect to claim deduction equal to cost basis and use the 50% AGI limit.

**If tangible personal property ("TPP") is unrelated to the donee's exempt purposes, donor is limited to deducting cost basis.[17]

[17] Chart adapted from Abbey M. Magnuson, note 8.

TO ELECT, OR NOT TO ELECT, S-CORP TAXATION
THAT IS THE QUESTION

JAMES P. DOSSEY, MBA, JD, CPA, *The Woodlands*
Dossey & Jones, PLLC

State Bar of Texas Tax Section
Tax Law in a Day
February 7, 2020
Houston, Texas

<u>DISCLAIMER</u>

NOTE: THIS OUTLINE IS FOR EDUCATIONAL PURPOSES ONLY. NOTHING HEREIN SHALL CONSTITUTE LEGAL ADVICE BY THE AUTHOR OR DOSSEY & JONES, PLLC. ANY TAX ADVICE CONTAINED IN THIS OUTLINE IS NOT INTENDED OR WRITTEN TO BE USED, AND CANNOT BE USED, FOR THE PURPOSE OF (I) AVOIDING PENALTIES UNDER THE INTERNAL REVENUE CODE OR (II) PROMOTING, MARKETING OR RECOMMENDING TO ANOTHER PARTY ANY TRANSACTION OR OTHER MATTER ADDRESSED HEREIN. EACH CASE VARIES DEPENDING UPON ITS FACTS AND CIRCUMSTANCES. ANYONE SEEKING TAX ADVICE SHOULD CONSULT WITH HIS OR HER TAX ADVISOR.

The author welcomes any corrections and suggestions for improvements to this outline

JAMES P. DOSSEY, MBA, JD, CPA

Dossey & Jones, PLLC
25025 I45 N. Ste. 575
The Woodlands, TX 77380
281-362-9909
jim@dossey.com

Jim Dossey is an attorney / partner at Dossey & Jones PLLC in The Woodlands, concentrating in complex business law, tax, estate planning, and intellectual property. Jim is a certified public accountant (CPA) and Board Certified in Estate Planning and Probate law.

Prior to becoming a lawyer, Jim worked at Bank of America for five years as a participant in the bank's prestigious Technology MBA Leadership Development Rotational Program. During his 5 years at the bank, Jim led a team of over 150 bank employees to implement various technology and organizational improvements. Before his role at Bank of America, Jim worked as a software consultant for five years at a small oil and gas consulting firm in Houston, Texas, where he designed and programmed gas plant accounting software.

In addition to his law degree from the South Texas College of Law, Jim holds an MBA in corporate finance and strategy from the MIT Sloan School of Management. Additionally, Jim holds a Bachelors of Science degree in Mechanical Engineering and a Masters of Science degree in Electrical Engineering from the University of Texas.

Outside of work, Jim is a legal advisor for the Legacy Foundation at the Ark Church in Conroe, Texas. Additionally, Jim is President of the Montgomery Independent School District school board and President and founding Board Member on the MISD Education Foundation. Jim is also Vice Chair of the Corporate Tax Section of the State Bar of Texas.

Awards and Recognition

- Texas Super Lawyers Rising Star, Thompson Reuters, 2019, 2020
- Tax Leadership Academy, 2017

TABLE OF CONTENTS

TO ELECT, OR NOT TO ELECT, S-CORP TAXATION, THAT IS THE QUESTION

I. INTRODUCTION

Entity taxation has long been an important driver in the selection of entity type for small business owners. Subchapter S of the Internal Revenue Code was originally passed into law in 1958 creating the "S Corporation". On December 22, 2017, the Tax Cuts and Jobs Act ("TCJA") was signed into law by President Donald J. Trump.[1] Among many changes to the tax code, the TCJA introduced two major changes to the tax law that will affect the choice of the election of S Corporation taxation for small businesses:

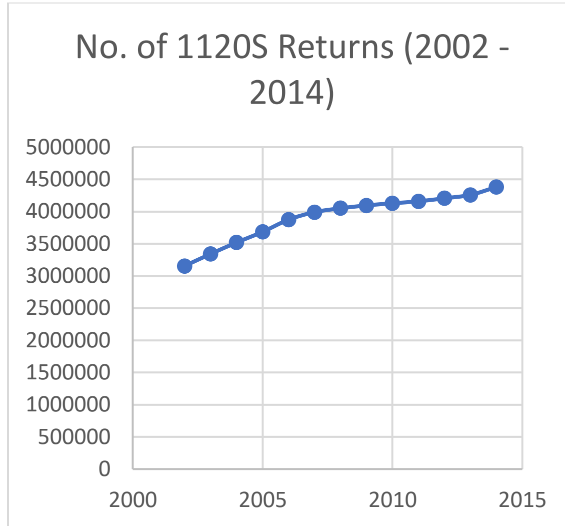
1) the TCJA permanently reduced the corporate tax rate from a maximum of 35% under a graduated tax rate structure to a flat 21%; and

2) the Qualified Business Income Deduction (199A).

The purpose of this paper is to reexamine the S Corporation election for small businesses considering the TCJA.

A. Business Owners Increasingly Elect S Corporation Taxation

IRS statistical data for S Corporations (2014, the last year available) shows that the number of S Corporations has steadily increased to a total of 4,380,125 1120s returns filed in 2014. Most S Corporations are small, averaging 1.65 shareholders and $115,694 net income.



B. The S-Corp Advantage?

1. <u>Avoidance of double tax regime (compared to C corporations)</u>

The primary benefit of S corporation taxation compared to C corporation taxation is the avoidance of the double tax regime. S Corporations are pass-through entities and therefore the earnings are only subject to one layer of taxation at the shareholder level. By comparison, C Corps are first taxed at the entity level (21% after TCJA went into effect). Earnings are again taxed when distributed to shareholders generally at 23.8%[2].

The following tables illustrate the effective tax results for the owners (making many assumptions). Prior to TCJA, the S Corporation tax advantage was much greater than it is today due to the reduction in the corporate tax rate from a maximum rate of 35% to a flat 21%. Now that the corporate tax rate has been reduced, the effect of the double tax regime is almost negligible for high earning taxpayers.

[1] An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, Pub. L. No. 115-97, § 11061 (2017)

[2] IRC §1(h)(11) (20% highest marginal qualified dividend federal income tax rate) and IRC §1411(a) (3.8% Net Investment Income tax rate)

In the example below, prior to the TCJA, $49.53 was left to shareholders in an C Corporation and $56.60 in an S Corporation. After the TCJA, $60.20 remained for shareholders in a C Corporation and $59.20 in an S Corporation.

C Corporation (Prior to 2017 TCJA)

Taxable Income	$100.00
Corporate Rate	35%
Corp Tax Liability	$35.00
Cash Avail to Shareholders	$65.00
Individual Rate	20%
Net Investment Income Rate	3.80%
Individual Tax Liability	$15.47
Total Tax Liability	$50.47
Net to Shareholders	$49.53

C Corporation (After 2017 TCJA)

Taxable Income	$100.00
Corporate Rate	21%
Corp Tax Liability	$21.00
Cash Avail to Shareholders	$79.00
Individual Rate	20%
Net Investment Income Rate	3.80%
Individual Tax Liability	$18.80
Total Tax Liability	$39.80
Net to Shareholders	$60.20

S Corporation (Prior to 2017 TCJA)

Taxable Income	$100.00
Corporate Rate	0%
Corp Tax Liability	$0.00
Cash Avail to Shareholders	$100.00
Individual Rate	39.6%
Net Investment Income Rate	3.80%
Individual Tax Liability	$43.40
Total Tax Liability	$43.40
Net to Shareholders	$56.60

S Corporation (After 2017 TCJA)

Taxable Income	$100.00
Corporate Rate	0%
Corp Tax Liability	$0.00
Cash Avail to Shareholders	$100.00
Individual Rate	37.0%
Net Investment Income Rate	3.80%
Individual Tax Liability	$40.80
Total Tax Liability	$40.80
Net to Shareholders	$59.20

2. <u>Flow-through of Corporate Losses to Owners (compared to C corporations)</u>

A second major reason that owners may prefer to elect S Corporation taxation over C Corporation taxation is the ability to pass losses through to owners of the business, subject to the following:

(a) the ability to pass such losses through to the owners is limited by a) stock and debt basis limitations, b) at risk limitations, and c) passive activity loss limitations; and

(b) the TCJA placed a limitation on the ability of offsetting income with excess business losses if the amount of the loss is in excess of $250,000 for individual taxpayers ($500,000 for joint returns).[3]

Net losses incurred by C Corporations are deducted from corporate income; they do not pass through to the shareholders.

3. <u>Potential self employment tax reduction (compared to partnerships)</u>

S Corporations may provide a tax advantage over partnerships by reducing self-employment tax. In a partnership, partners are subject to self-employment tax on earnings generated from active involvement in the business. Limited partners in a limited partnership may exclude self-employment tax but general partners are subject to self-employment tax on their distributive share of the income.[4] Courts have generally imposed self-employment tax on all members of limited liability companies unless they lack management authority and don't provide significant services to the business.[5]

With an S Corporation, however, shareholders that actively participate in the business take and pay self-employment tax on a salary. Distributions in excess of the salary are treated as passive income and are not subject to self-employment tax. The salary must be "reasonable" as defined in numerous IRS revenue rules and tax court cases.[6]

The following illustrates a very simplified example of a married couple with earnings of $300,000 and a salary of $100,000. The federal income tax liability is the same for the S Corporation and the partnership, but the S Corporation results in over $10,000 in self-employment tax savings.

S Corporation (After 2017 TCJA)

Earnings	$200,000.00
Salary	$100,000.00
Standard Deduction	$24,800.00
Taxable Income	$275,200.00
Effective Individual Rate	20.0%
Individual Tax Liability	$55,040.00
<u>Self Employment Tax</u>	
Social Security (12.4% to $137,700)	$12,400.00
Medicare tax (2.9%)	$2,900.00
Total Tax Liability	$70,340.00
Net to Owners	$229,660.00

Partnership (After 2017 TCJA)

Earnings	$300,000.00
Salary	$0.00
Standard Deduction	$24,800.00
Taxable Income	$275,200.00
Individual Rate	20.0%
Individual Tax Liability	$55,040.00
<u>Self Employment Tax</u>	
Social Security (12.4% to $137,700)	$17,074.80
Medicare tax (2.9%)	$8,700.00
Total Tax Liability	$80,814.80
Net to Owners	$219,185.20

[3] TCJA amended IRC § 641(I).

[4] IRC § 1402(a)(13).

[5] Proposed Regs. Sec. 1.1402(a)-2.

[6] Guidance from the IRS provided at https://www.irs.gov/businesses/small-businesses-self-employed/paying-yourself

4. Eligibility for the Qualified Business Income Deduction

The TCJA added Section 199A, also known as the Qualified Business Income deduction.[7] Section 199A provides a potential pass-through deduction equal to 20% on allocable "qualified business income".

The relevant portion of 199A[8] is as follows:

> (2) DETERMINATION OF DEDUCTIBLE AMOUNT FOR EACH TRADE OR BUSINESS. The amount determined under this paragraph with respect to any qualified trade or business is the lesser of-
>
> (A) 20 percent of the taxpayer's qualified business income with respect to the qualified trade or business, or
>
> (B) the greater of-
>
> (i) 50 percent of the W-2 wages with respect to the qualified trade or business, or
>
> (ii) the sum of 25 percent of the W-2 wages with respect to the qualified trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property.

Many articles have been written in detail about Section 199A, so this paper will focus on several important aspects of Section 199A as they relate to the choice of S Corporation taxation:

(a) No C Corporations. Section 199A does not apply to C corporations.

(b) Specified Trades or Businesses. Section 199A does not apply to businesses that are not a "qualified trade or business"[9], which includes doctors, lawyers, accountants, and others. Many of the businesses that would potentially benefit from S Corporation taxation to reduce self-employment tax do not qualify for the 199A deduction. For these types of businesses, the decision to elect S Corporation taxation does not depend on the 199A deduction.

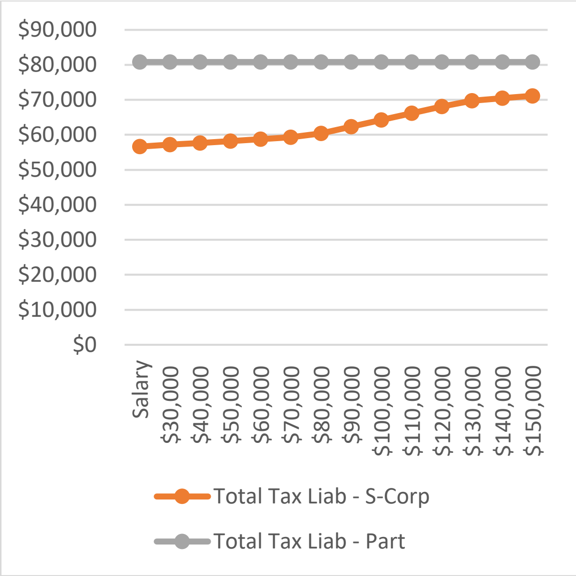
(c) Sole Proprietorships. Sole proprietorships and entities taxed as sole proprietorships such as single member limited liability companies (i.e. disregarded entities) do not have employees and cannot pay the owner W-2 wages. Because they do not pay W-2 wages, the 199A deduction is calculated as $0. By converting to S corporation taxation, the owner may now take a W-2 wage and may have a 199A deduction.

The graph below shows a business owner's total tax liability in a very simplified tax scenario of a married taxpayer with $300,000 in earnings from a sole proprietorship; many assumptions have been made. As can be seen in the graph, the owner's tax liability is reduced significantly if S Corporation taxation is elected compared to partnership taxation.

[7] IRC § 199A.

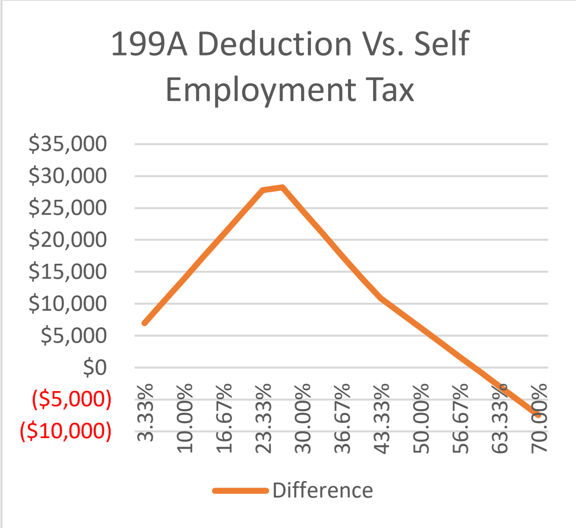
[8] IRC § 199A(b)(2).

[9] IRC § 199A(d).



(d) Tradeoff: 199A Deduction Vs. Self-Employment Tax. To get the greatest reduction in self-employment tax, the business owner is encouraged to reduce his salary to the lowest reasonable salary possible. However, this conflicts with Section 199A, where the deduction amount in part depends on increasing W-2 wages, at least up to the point where 50% of such wages equals 20% of the taxpayer's qualified business income. In other words, the effort to reduce self-employment tax may also reduce the amount of possible 199A tax deduction.

The graph below shows the difference between the 199A deduction and the self-employment tax incurred for a very simplified tax scenario for a married taxpayer with $300,000 in earnings where the business has elected S Corporation taxation and the owner is taking a salary. The x axis represents the ratio of salary to earnings and the y axis represents the difference between the 199A deduction and self-employment tax. As can be seen in the graph, in this scenario the optimal salary vs. earnings percentage is about 27-28%.



I. S-CORP BASICS

A. S-Corporation Defined: 26 US Code Section 1361

Internal Revenue Code Section 1361(a) defines an S Corporation as "a small business corporation for which an election under section 1362(a) is in effect for such year."[10]

Section 1361(b)(1) further defines the term "small business corporation" which does not

(a) have more than 100 shareholders,

(b) have as a shareholder a person who is not an individual, [11]

(c) have a nonresident alien as a shareholder, and[12]

(d) have more than 1 class of stock.

[10] IRC § 1361(a)

[11] LLCs treated as disregarded entities also are eligible shareholders's. See IRS Letter Rulings 9745017, 200107025, 200303032, and 200513001.

[12] TCJA Update: nonresident alien may be a potential current beneficiary of an electing small business trust (ESBT) and the ESBT will not become a disqualified SH. (Tax Cuts and Jobs Act (TCJA), P.L. 115-97)

Furthermore, certain corporations are ineligible to make S elections, including:[13]

(a) foreign corporations

(b) financial institutions which use the reserve method of accounting for bad debts

(c) certain insurance companies,

(d) current or former domestic international sales corporations, and

(e) former S Corporations who have terminated their S-election within the prior five years.

B. S-Corp Election, Revocation, and Termination: 26 U.S. Code § 1362

1. How to elect.

Entities must expressly elect to be taxed as an S Corporation by filing IRS form 2553.[14] All shareholders must consent to the S Corporation election.[15]

2. When to elect.

An S Corporation election may be made by a small business corporation for any taxable year

(a) at any time during the preceding taxable year, or

(b) at any time during the taxable year and on or before the 15th day of the 3rd month of the taxable year.[16]

However, a late election may be treated as timely under certain circumstances if the IRS determines there was reasonable cause for the failure to timely make such election.[17]

The IRS has also provided late election relief under Rev. Proc. 2013-30. S Corporation elections can be made up to 3 years and 75 days after the date for which the S election is intended to be effective. The election form must state at the top of the document "FILED PURSUANT TO REV. PROC. 2013-30." After the late election relief period has passed, taxpayers can also pursue a private letter ruling.[18]

3. Termination.

An S Corporation election may be terminated voluntarily by revocation or involuntarily. For voluntary terminations, more than half of shares must consent to revocation.[19] As a consequence of voluntary termination, the small business is not eligible to re-elect S Corporation taxation for 5 years after the year the termination is effective.[20]

An S Corporation election may also involuntarily terminate if the entity ceases to qualify as a small business corporation, for example, if the entity has more than 100 shareholders, a shareholder is not eligible to be a shareholder in an S Corporation, or if the S Corporation has more than one class of stock.[21]

III. REASONS TO NOT ELECT S CORPORATION TAXATION

Despite certain advantages of S Corporation taxation, there are many scenarios where an S

[13] IRC § 1361(b)(2)

[14] See https://www.irs.gov/forms-pubs/about-form-2553

[15] IRC § 1362(a)(2)

[16] IRC § 1362(b)(1)

[17] IRC § 1362(b)(5)

[18] Rev. Proc. 2019-1

[19] IRC § 1362(d)(1)

[20] IRC § 1362(g)

[21] IRC § 1362(d)(2)

Corporation election would be inappropriate or detrimental to the taxpayer.

A. What are the client's plans for the future? Does the client plan to exit the business at some point?

1. S-Corp restrictions may discourage potential buyers (i.e. VC firms)

By electing S Corporation taxation, the business may be less attractive as an acquisition target. First, the ownership structure of many venture capital firms may cause an automatic termination of S Corporation status. Many VC's have owners that are themselves partnerships or they may have foreign owners, both which are not eligible owners of an S Corporation.

Second, the ownership of many VC firms (i.e. foreign ownership, greater than 100 owners, etc.) may make structuring an acquisition difficult. For example, the S Corporation requirements may make a stock purchase of an S Corporation difficult to structure. Therefore, an acquirer may be forced to structure the acquisition as an asset purchase (rather than a stock purchase) or the acquirer may purposely terminate the S Corporation status.

Finally, many VC's simply may not want to deal with the complexity of pass through taxation for its owners.

2. Do they want to grow the company to have more than 100 shareholders?

The S Corporation election may place limits on growth of the company. For example, the S Corporation limitation of 100 shareholders can be reached faster than the owners might expect, especially if the owner wants to offer stock as an employee incentive.

Furthermore, problems can arise if the company has already reached the 100 shareholder limit but still needs to raise capital. The company would not be able to bring in new shareholders without terminating the S Corporation status.

3. Restriction to one class of stock.

Potential investors often require preferred returns or separate classes of stock. For example, such investors may require shares that have a preferred return within a distribution waterfall or shares that have preferential voting rights over other shares. The S Corporation restriction to one class of shares does not allow for preferential treatment of some shareholders over other shareholders. Differences in voting rights are disregarded (i.e. voting and non-voting shares are allowed), but each shareholder must have equal distribution and liquidation rights.

4. Section 1202 deduction only available for C Corporations

Under IRC Section 1202, the gain on the sale of "Qualified Small Business Stock" held for five years or more may be partially or entirely excluded from income.[22] "Qualified Small Business Stock"[23] is defined as any stock in a C Corporation what when originally issued the corporation was a qualified small business.

Section 1202 simply is not available for partnerships and S Corporations. If the owner is thinking about exiting the business in 5-10 years and the business qualifies under Section 1202, the owner should carefully consider whether the potential interim tax reduction provided by S Corporation taxation outweighs the gain exclusion under 1202.

Furthermore, a taxpayer cannot convert from a S Corporation to a C Corporation and have access to Section 1202. The issuing corporation must be a C Corporation at the time of issuance of the stock. That said, the S Corporation converted to

[22] IRC § 1202.

[23] IRC § 1202(c).

a C Corporation can issue new shares for new consideration after the conversion. The new shares may qualify for Section 1202 if at the time of issuance the company is still a qualified small business.

B. Will the client have foreign ownership, now or in the future?

A corporation having a nonresident alien does not qualify as a small business corporation. A nonresident alien is an individual that has not been legally admitted for permanent residence and has not met the substantial presence test.[24] If the entity has nonresident alien shareholders, or may have them in the future, it simply does not qualify for the S Corporation election. Therefore, partnership or corporate taxation must be chosen.

C. Is the intent to reinvest most / all of the funds back in the business?

If the business owner intends to reinvest earnings back in the business, a C Corporation may be a better choice than an S Corporation. With the reduction in the corporate tax rate to 21% under the TCJA, a taxpayer may invest a greater portion of funds in the business as a C Corporation compared to a pass-through entity. The C Corporation advantage is especially important for wealthy taxpayers subject to high marginal tax rates. Additionally, this benefit increases as the growth rate and holding period on the reinvested funds increases.[25]

The following table is a simple example showing this effect. On $100 in earnings, $79 may be reinvested back in the company in a C Corporation whereas only $59 is available to reinvest in an S Corporation.

C Corporation (After 2017 TCJA)

Taxable Income	$100.00
Corporate Rate	21%
Corp Tax Liability	$21.00
Cash Avail to Reinvest	$79.00

S Corporation (After 2017 TCJA)

Taxable Income	$100.00
Corporate Rate	0%
Corp Tax Liability	$0.00
Cash Avail to Shareholders	$100.00
Individual Rate	37.0%
Net Investment Income Rate	3.80%
Individual Tax Liability	$40.80
Total Tax Liability	$40.80
Cash Avail to Reinvest	$59.20

D. Will the client own real estate or other appreciating assets?

Like C Corporations, S Corporation are subject to tax on certain built-in-gains.[26] Built-in-gains ("BIG") are defined as the difference between the fair market value of the S Corporation assets and the aggregate adjusted basis of such assets at that time. BIGs are recognized on the sale or disposition of an asset.

[24] IRC § 7701(b)(1)(B).

[25] The ability to stockpile assets in the C-corp is limited to the accumulated earnings tax (Section 531). Safe harbor of $250k (Section 532(c)(2)) unless there are provable business needs.

[26] IRC § 1374.

For any tax year in which there is a BIG, there is an additional tax imposed by applying the highest marginal tax rate (currently 21% due to TCJA) to the BIG. Although the taxpayer never wants to incur the BIG tax, prior to the reduction in the corporate tax rate due to the TCJA the taxpayer would incur BIG tax at a much higher rate.

The imposition of the BIG tax is limited in the following ways:

1) The BIG tax only applies to asset dispositions during the first 5-year period after the effective date of the S Corporation tax election[27];

2) The BIG tax does not apply to any corporation which has always been taxed as an S Corporation[28];

3) The BIG tax is also limited to income tax that would have been incurred as a C-Corporation. Therefore, a taxpayer can avoid the BIG tax if the entity has no taxable income for the first 5 years.

Because of the BIG tax, it is generally detrimental to hold appreciating assets (or assets that are subject to depreciation) in a S Corporation, especially if the owner intends to dispose of the assets within the 5 year recognition period (i.e. selling the assets, distributing the assets in-kind to the shareholder, gifting the property to a child, etc.). Under partnership taxation, on the other hand, there is no immediate tax impact of distributing the property from the partnership.

Note that a real estate "flipper" is less effected by the BIG tax because they do not intend to buy and hold the property for a long period of time. Additionally, property developers are subject to both ordinary income tax and self employment tax on the proceeds of a real estate sale.

E. Will the client's earnings outweigh the costs of maintaining the S-election?

From a practical standpoint, the taxpayer will incur additional costs to maintain an entity with an S Corporation election. For example, the taxpayer will be required to run payroll to pay salaries from the S Corporation. Typical costs for online payroll software costs approximately $25-200 per month. Additionally, the S Corporation will also require an 1120s tax return each year. According to the 2016-17 NSA Income and Fees of Accountants and Tax Preparers in Public Practice Survey Report, the average cost of an 1120s tax return was $809.

Although the S Corporation election can result in a significant reduction in self-employment tax, the costs of maintaining the must be considered when deciding if the tax savings outweighs the additional costs, especially for disregarded entities that do not require payroll or a federal income tax return.

F. Is the client a high income investor?

High income passive investors in the highest tax brackets will not see significant benefits from pass-through S Corporation taxation, especially if the businesses do not qualify for the 20% deduction. In 2020 the highest individual marginal tax rate is 37% (which will revert back to 39.6% in 2026). In a C Corporation, however, the investor would incur an effective tax rate of 39.8% (21% at the corporation level + 23.8% for dividends*79%). Note that an active investor receiving W-2 wages will potentially see a self-employment tax reduction in a S Corporation compared to partnership taxation.

[27] IRC § 1374(d)(7).

[28] IRC § 1374(c)(1).

G. Will the client want to make disproportionate distributions to certain Shareholders? Disproportionate allocations of profits and losses?

S Corporations cannot disproportionately allocate profit among the shareholders. Distributions of profit must be proportionate according to the shareholder's ownership in the entity.

The proportionate distribution rule is based on the requirement of one class of stock[29]. Tax regulations provide that "a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds." Therefore, an S Corporation cannot have disproportionate distributions because that would imply more than one class of stock.

Deemed disproportionate distributions can result in inadvertent termination of S-Corp status. Limited liability companies and limited partnerships that elect S Corporation taxation should evaluate partner's rights carefully within the partnership agreement to determine if multiple classes of stock are created inadvertently (for example, liquidating distributions based on capital accounts rather than ownership of units).

Partnerships can make disproportionate distribution without any issues. Partners may desire to distribute profit disproportionately for a variety of practical reasons, such as when one partner contributes more to the partnership than other partners of equal ownership.

H. Does the client want to offer different retirement benefits to select employees?

Contributions must be the same to all eligible employees of the S Corporation retirement plan. A shareholder cannot make a large contribution to their retirement plan without making the same contribution to the retirement plans for all eligible employees. For example, the owner / physician in a doctor's office may desire to make a large contribution to their SEP IRA. If the entity is taxed as an S Corporation, they would also have to make the same proportionate distribution to the staff employed by the entity.

I. Will the client use the stock of the company for estate planning purposes?

From an estate planning standpoint, S Corporations are not ideal. First, the single class of stock requirement makes succession planning more difficult. Parents often transfer ownership in the family business by making gifts or sales of stock to their children. The requirement of one class of stock limits the options that are available to the parent passing S Corporation stock ownership to their children. Notwithstanding the single class of stock rule, IRS Regulations do provide that the entity can issue voting and non-voting stock, which if identical in all other respects, including distributions and liquidations, will not be treated as different classes of stock within the meaning of § 1361(b)(1)(D).[30]

Second, only certain kinds of trusts can hold S Corporation stock such as grantor trusts, qualified revocable trusts, qualified subchapter S trusts (QSST)[31] and electing small business trusts (ESBT)[32]. Grantor trusts become non-grantor trusts (and therefore ineligible S Corporation shareholders) upon the death of the grantor. In this case, the grantor trust can only hold S Corporation shares for at most 2 years after the date of death of the deceased grantor.[33] Similarly, a testamentary trust created by a Last Will and

[29] Section 1.1361-1(l)(1) of the Income Tax Regulations

[30] IRC § 1361(b)(1)(D) and Section 1.1361-1(l)(1) of the Income Tax Regulations.

[31] IRC § 1361(d)(1).

[32] IRC § 1361(c)(2)(A)(v).

[33] IRC § 1361(c)(2)(A)(ii).

Testament can hold S Corporation stock for at most 2 years after the date in which the shares were transferred to such trust.[34]

These limitations make it difficult to implement complicated estate planning techniques used by parents to transfer their business to their children and maintain the S Corporation election.

J. Fringe benefits

Businesses often use fringe benefits to compensate employees. In general, fringe benefits are taxable income to the employee, with the exception of certain fringe benefits.[35] Excludable fringe benefits include, among others, the cost of group-term life insurance, amounts paid for or to an accident or health plan, health savings accounts, and meals and lodgings furnished for convenience of the employer.

In general, certain fringe benefits provided by a S Corporation are not taxable to employees. However, employees that own 2% or greater of a company are treated like partners in a partnership for the purposes of determining taxability on fringe benefits, rather than employees[36]. In these cases, most fringe benefits are taxable to the employee, including premium payments for employee owned life insurance, health insurance premiums, accident insurance premiums, disability insurance premiums, long-term care insurance premiums, personal use of a company car, lodging, and meals. For employees that own 2% or greater of the company shares, such fringe benefits are recognized as wages and included in the employee's W-2 wages, subject to regular federal withholding and employment tax withholding. Furthermore, if the S Corporation fails to properly report such fringe benefits as compensation, the IRS may determine that unequal distributions have been made to such shareholder (violating the single class rule), potentially terminating the S Corporation election.

IV. CONCLUSION

With the high C Corporation tax rates prior to the TCJA, the benefits of pass through taxation and a reduction in self-employment tax made the election of S Corporation taxation very attractive in many cases. However, given the new corporate tax rate of 21% and the 199A tax deduction, the analysis has become more complex as to determine advisability of the S Corporation election. Furthermore, other factors such as treatment of fringe benefits, retirement planning, estate planning, and the short and long-term goals of the business owner can become important in the S Corporation decision.

Politics must also be considered in the decision to elect S Corporation taxation. With the presidential election in 2020 and congressional election in 2022, a dramatic shift in tax policy could affect tax planning and strategy. Because S Corporation elections cannot be resubmitted for 5 years after revocation, a business owner could be stuck with a bad choice until the 5-year term runs. Most of the provisions of TCJA are set to automatically expire after 2025, which will again alter the analysis. The 21% corporate tax rate is permanent, but even that could change if the elections result a change in power in Washington.

Given this uncertainty, is it wise to make significant structural tax changes? Perhaps the best approach is to use multiple entities to segregate business units to optimize overall taxation for the client.

[34] IRC § 1361(c)(2)(A)(iii).

[35] IRC § 132.

[36] IRC § 1372

PROPOSED CHANGES TO THE TEXAS DISCIPLINARY RULES OF PROFESSIONAL CONDUCT

Bob Probasco, Co-Chair, Pro Bono Committee

The State Bar is currently holding an election on proposed changes to the Disciplinary Rules of Professional Conduct, with voting conducted during the period from February 2nd to March 4th. A summary of the proposed amendments is available here; more detail is available here; and you can register here for a free public forum webinar on February 9th about the proposed amendments. The public forum includes a one-hour CLE presentation by members of the Committee on Disciplinary Rules and Referenda, which also counts as legal ethics credit. It will be followed by a live forum at which attendees can ask questions and provide comments. If you cannot attend the live forum, videos of earlies public forums are available for self-study credit here.

The Tax Section's Pro Bono Committee wants to bring to your attention ballot item D, concerning exceptions to conflict of interest rules for nonprofit and limited pro bono legal services. That item adds a new Rule 6.05, which may impact section members who volunteer for our Tax Court calendar call program. Our volunteers show up at Tax Court trial sessions and offer free consultations to unrepresented taxpayers who come to court. That may involve evaluating the strength of their case and any settlement offers from the IRS, explaining court procedures, or helping them prepare for trial. These taxpayers are usually unable to hire private practitioners to represent them. Alternatively, a case may involve a deficiency that would pose a significant burden to the taxpayer but is too small to justify the cost of hiring an attorney. Without free assistance, the taxpayers cannot effectively navigate their way through the complications of a Tax Court trial.

Conflicts of interest requirements can be a problem for our volunteers. When volunteers first meet and identify the taxpayer at the calendar call, there is little time to perform a conflicts check. Although these representations may be unlikely to create a conflict, proceeding with representation without a conflicts check is a risk that could inhibit section members from volunteering.

The ABA Model Rules of Professional Conduct have long had a provision addressing the problem and providing relief from stringent conflicts of interest requirements. Model Rule 6.5 applies to lawyers who provide short-term limited legal services under the auspices of a program sponsored by a nonprofit organization or court. It provides that volunteer is subject to conflicts of interest rules only if he/she actually knows that the representation involves a conflict of interest. The imputation of conflicts by other members of the same firm also does not apply unless the volunteer actually knows that another lawyer in the firm would be disqualified with respect to that representation. However, the Texas Disciplinary Rules of Professional Conduct do not have a comparable provision.

Proposed Rule 6.05 is carefully crafted to provide a narrow exception to the conflicts of interest requirements. We urge your support for ballot item D.

Property Tax Litigation Update:
Courts Are Limiting the Scope of Discovery in Equal and Uniform Lawsuits

By Stephen Grant, Associate
Popp Hutcheson, PLLC

The scope of permissible discovery in equal and uniform lawsuits has been debated for decades. Appraisal districts routinely serve discovery requests seeking sales prices, bank information, loan documents, financing agreements, and appraisal reports previously prepared for financing purposes. Naturally, these requests are met with resistance from property owners, who claim that such information is irrelevant and unnecessary to determine an unequal appraisal challenge. The disagreement regarding what is discoverable and what is not has been based on apparent confusion regarding the nature of the equal and uniform remedy. To some property owners, though, it seems more like an appraisal district attempt to engage in a fishing expedition for financial records and appraisal reports unrelated to their property tax lawsuit.

When contesting appraised values, Texas property owners have two basic remedies. They can claim that their appraised value is excessive (i.e., above market value). Tex. Tax Code § 42.25. They can also claim that their property has been unequally appraised (i.e., has not been appraised in an equal and uniform manner when compared to other properties). Tex. Tax Code § 42.26. The Texas Tax Code provides an efficient cause of action for correcting unequal appraisal. Specifically, Section 42.26(a)(3) provides that a "district court shall grant relief on the ground that a property is appraised unequally if the appraised value of the property exceeds the median value of a reasonable number of comparable properties appropriately adjusted." This remedy is rooted in the Texas Constitution's mandate that "[t]axation shall be equal and uniform." Tex. Const. art. VIII, § 1(a). The guarantee of equal and uniform taxation is so important that a number of courts have held that, "[i]f a conflict exists between taxation at market value and equal and uniform taxation, equal and uniform taxation must prevail." *Harris County Appraisal District v. United Investors Realty Trust*, 47 S.W.3d 648, 654 (Tex. App.—Houston [14th Dist.] 2001, pet. denied); *see Harris County Appraisal District v. Kempwood Plaza Ltd.*, 186 S.W.3d 155, 162 (Tex. App.—Houston [1st Dist.] 2006, no pet.).

Over the last three years, courts of appeals have considered the permissible scope of discovery in equal and uniform lawsuits. They have ruled that appraisal reports, sales prices, and other information concerning the "market value" of property are generally irrelevant and not discoverable. The scope of discovery for equal and uniform lawsuits, accordingly, is remarkably different and more restrictive than lawsuits contesting "above market" appraised values.

In *In re Catherine Tower, LLC,* the Austin Court of Appeals prohibited the Travis Central Appraisal District from obtaining any "appraisals, valuations, or estimates of value performed in connection with the loan" concerning a luxury high-rise apartment complex. 553 S.W.3d 679, 682, 686–687 (Tex. App.—Austin 2018, orig. proceeding [mand. denied]). The property was financed through a bank loan, which originated from a financing agreement that included extensive financial and business information regarding the property and its owner. In rejecting the "litigation tactics of the local appraisal district," the court explained that unequal appraisal actions do "not hinge upon whether the subject property's appraisal is consonant with its market value." In its reasoning, the court stated that while detailed information in a financing report may have some relevance to a property's market value, similar information is not permitted to prove an unequal appraisal claim. The opinion underscored that an equal and uniform action is an independent claim that "stands in contrast to a taxpayer's challenge to the underlying determination of the appraised value in itself . . . ."

Similarly, in *In re APTWT, LLC*, the Houston Fourteenth Court of Appeals clarified that, for purposes of equal and uniform lawsuits, sales prices found in closing statements and value opinions stated in appraisal reports are irrelevant. 612 S.W.3d 85, 90–91 (Tex. App.—Houston [14th Dist.] 2020, orig. proceeding [mand. pending]) (application for mandamus filed January 29, 2021). The court prohibited the Harris County Appraisal District from accessing "appraisals, sales documents, and closing statements" arising out of the purchase of an apartment complex. Agreeing with *In re Catherine Tower*, the court explained that if "proof of market value is not required [in equal and uniform lawsuits] and market value does not prevail over uniform taxation in a property owner's unequal appraisal action . . . , then it logically follows that evidence of market value of the subject property is not necessarily relevant in such action." The opinion further highlighted that relief under Section 42.26(a)(3) of the Texas Tax Code does not independently determine the market value of either the subject property or the comparable properties.

These two opinions provide a bright-line rule prohibiting market value-related discovery in equal and uniform property tax valuation lawsuits. The one minor exception is for portions of appraisal reports and financing records that provide detail about the selection of comparable properties and the application of appropriate adjustments (i.e., property size, age, and depreciation). As clearly stated in *In re Catherine Tower*, to determine the merits of an equal and uniform claim, "one merely takes the appraised values of the subject property and of the comparison properties as 'found on the tax rolls' and compares them, and 'the only independent analysis required is adjusting the appraised values [of the comparison properties] to put the properties on equal footing.'" *In re Catherine Tower*, 553 S.W.3d at 686. Courts are protecting the efficiency of this remedy by confirming the limited scope of discovery.

New user fee proposed for estate tax closing letters

January 06, 2021

The Internal Revenue Service (IRS) issued proposed regulations establishing a new user fee of $67 for authorized persons who wish to request the issuance of an estate closing letter. This will apply to requests received by the IRS 30 days after the regulations become final.

An estate closing letter informs the authorized person of the acceptance of the Form 706 estate tax return and also contains other tax information including the amount of the net estate tax, the state death tax credit or deduction, and any generation skipping transfer tax. An authorized person refers to a person properly authorized under section 6103 of the Internal Revenue Code (Code) to receive and request an estate closing letter with respect to the estate, which includes, but is not limited to, the executor, personal representative or authorized party under an executed Form 2848, Power of Attorney and Declaration of Representative. The executor is responsible for addressing unpaid estate liabilities including estate taxes and can be held personally liable for the payment of tax under certain circumstances. The estate tax closing letter explains that the IRS will not reopen or examine the estate tax return to determine the estate tax liability of a decedent's estate unless the estate notifies the IRS of changes to the estate tax return or if there is (1) evidence of fraud, malfeasance, collusion, concealment or misrepresentation of a material fact, (2) a clearly defined substantial error based upon an established IRS position or (3) a serious administrative omission. The closing letter does not indicate whether estate tax has been paid but it provides the executor with information regarding the estate tax liability so that assets may be divided, distributed and the estate may be closed.

The estate tax closing letter is not required by the Code but has been a practice offered to aid in estate administration. The IRS issued an estate closing letter for every estate tax return filed until June 2015 when the IRS issued this letter on request by an authorized person. An alternative method was provided by obtaining an account transcript in lieu of the previously issued estate closing letter that included Transaction Code 421 which indicated the return was accepted as filed or the examination is complete.

The IRS estimates the number of estate tax returns filed in 2018 to be 30,500 with a large number of these filings electing portability of the DSUE amount for the surviving spouse. Since the closing letter is viewed by the IRS to be a convenience offered to the estate, it has been determined that a user fee would be appropriate to assist in recovering the costs incurred to provide this service. The IRS has proposed implementing a web-based system to request the estate closing letter and collect the user fee using the existing www.pay.gov website. This new “one-step, web-based procedure” is expected to improve efficiencies for both the estate and the IRS.

AUTHORS

Rebecca Warren
Senior Manager

Lee Ann Couture
Manager

Originally published as a Tax Alert by RSM US LLP; reprinted with permission.

PROPERTY TAX UPDATE

TEXAS COURTS OF APPEALS

SECTION 25.25(C)(3) MAY NOT BE USED TO CORRECT ERRORS AS TO WHICH TAXING JURISDICTIONS A PROPERTY IS LOCATED. TAXES DO NOT BECOME DELINQUENT UNTIL 125 DAYS AFTER A TAXPAYER FIRST BECOMES AWARE THAT TAXES WERE DUE.

SPX Corp. v. Altinger, 14-19-00057-CV, 2020 WL 6791065 (Tex. App.—Houston [14th Dist.] Nov. 19, 2020, no pet. h.).

In tax years 2010 – 2013, a company owned taxable business personal property in Houston. The Chief Appraiser became aware that the appraisal district had misidentified the taxing units applicable to the company's physical location. The Chief Appraiser sought to correct this error under section 25.25(c)(3), claiming that the property did not exist "at the location described in the appraisal roll." The Chief Appraiser mailed a copy of the section 25.25(c)(3) motion to the taxpayer's agent, who misplaced the letter. As a result, the company did not protest or otherwise challenge the motion to correct error, and the appraisal review board corrected the identities of the taxing jurisdictions. Upon learning of this action, the agent filed a protest for lack of notice. The appraisal review board denied the protest because the taxpayer failed to timely pay the property taxes based on the new taxing jurisdictions, and the taxpayer failed to protest the section 25.25(c)(3) motion. The court found that the taxpayer had timely paid the taxes because section 41.44(c)(3) "[extended] [the deadline for tax payment] to the 125th day after the property owner claims to have first received written notice of the taxes in question."

On appeal, the appraisal district claimed the trial court lacked jurisdiction because the company failed to exhaust its administrative remedies under the Chief Appraiser's section 25.25(c)(3) motion to correct the location of the company's property. The court of appeals disagreed, reasoning that "the filing of a motion to correct a property's location under section 25.25(c)(3), without more, is not an action subject to protest." The appraisal district further argued that section 25.25(c)(3) allowed it to correct erroneous listing of taxing jurisdictions. The appellate court disagreed, finding "location means the property's physical location." The court stated, "to receive a section 25.25(c)(3) correction, the appraisal roll must erroneously reflect that a particular form of property exists at a specific location, and, in fact, no such property exists at that location." The appraisal district attempted to argue that "location" for purposes of section 25.25(c)(3) meant the property's taxable situs, but the court rejected the argument, explaining that section 25.25(c)(3) does not authorize a party to challenge "the extent to which business personal property located in a particular jurisdiction is taxable in that jurisdiction." Because the Chief Appraiser's motion did not seek to change the physical location of the property, but instead sought to change the appraisal roll's identification of the taxing units in which the property was taxed, the court rejected the plea to the jurisdiction.

APPRAISAL DISTRICT MUST CONSIDER THE ENTIRETY OF AN AGRICULUTRAL OPERATION IN DETERMINING WHETHER PROPERTY QUALIFIES FOR OPEN-SPACE USE DESIGNATION.

Hood County Appraisal Dist. v. Mandy Ann Mgmt. Ltd., 02-19-00294-CV, 2020 WL 6601595 (Tex. App.—Fort Worth Nov. 12, 2020, no pet. h.) (mem. op.).

A company owned approximately 680 acres of land in Hood County. The appraisal district sent notices to the company determining that a change of use occurred on the northern 240 acres of the tract because that area was being operated as a rock quarry. In response, the owner claimed that it had historically used all 680 acres for grazing livestock, and that the cattle continued to graze the entire 680-acre tract, including the area where the quarry was situated. A jury unanimously found in favor of the landowner and agreed that the 240-acre tract qualified as open-space land. The appraisal district appealed the jury's verdict, arguing there was insufficient evidence to support the jury's decision. The crux of the appraisal district's argument focused on the northern 240 acres, emphasizing the commercial nature of the rock quarry operation and ignored the remainder of the entire 680-tract. The owner argued that agricultural activity on the entire 240-acre property should not be considered in isolation and that, when viewed in its entirety, all of the 680 acres should qualify for the open-space designation. The jury heard from neighboring landowners who testified that livestock, specifically cows, frequently roamed on the subject property. The jury heard evidence regarding the "holistic view" as to how the entire 680-acre tract was used for livestock purposes. The Court of Appeals weighed all of the evidence and found in favor of the taxpayer, noting that "The [appraisal district], in contrast, tried to focus the jury's attention exclusively on the 239.51 acres in the northwest quarry where the quarry was located," despite legal authority and instructions to consider the "entire agricultural operation as a unit" if a property owner ranched several tracts as a unit. In conclusion, the court found that appraisal districts may not fixate on a portion of a multi-tract unit of land used for agricultural or livestock purposes, and may not may not disqualify discrete parcels of farm or ranchland on the basis that a particular parcel of property, in isolation, is not used primarily for livestock or agricultural purposes. Instead, the appraisal district is required to consider the entirety of an agricultural operation of the unit.

REAL PROPERTY LEASED BY A GOVERNMENTAL ENTITY DOES NOT QUALIFY FOR PROPERTY TAX EXEMPTION.

Dallas Cent. Appraisal Dist. v. City of Dallas, 05-19-00875-CV, 2020 WL 6334805 (Tex. App.—Dallas Oct. 29, 2020, no pet. h.), reh'g denied (Dec. 21, 2020) (mem. op.).

The City of Dallas filed a lawsuit appealing the appraisal district's order denying the City's request for a public property tax exemption for property leased by the City. The property was owned by a private entity but was used exclusively for a public purpose. The City argued it was entitled to an exemption pursuant to section 11.11 of the Texas Tax Code (which exempts property from taxation if it is owned by a political subdivision and used for a public purpose). The City owned the leasehold and used the property for a public purpose. The appraisal district countered that exemptions are only allowed if a governmental entity owns the property at issue. The Dallas Court of Appeals agreed with the appraisal district and denied the City's request for exemption.

APPRAISAL DISTRICT MAY NOT PROCEED TO TRIAL AND OBTAIN A VALUATION DETERMINATION IN DISTRICT COURT IF THE PLAINTIFF TAXPAYER FAILS TO APPEAR FOR TRIAL.

Firststone Heights LLC v. Travis Cent. Appraisal Dist., 03-19-00108-CV, 2020 WL 6478414 (Tex. App.—Austin Oct. 28, 2020, no pet. h.) (mem. op.).

A property owner filed suit to contest the order of the Travis County Appraisal Review Board setting the value of its property. The owner failed to appear for trial; however, the appraisal district appeared, announced ready, and the trial court allowed the trial to proceed in the absence of the property owner. The court rendered judgment fixing the appraised value of the property based on the evidence and arguments presented by the appraisal district at trial. The owner filed an appeal from the trial court's judgment, arguing the proper remedy was dismissal of the case. The Austin Court of Appeals agreed with the property owner and held, "When a plaintiff fails to appear and prosecute his case, the trial court cannot try the plaintiff's cause of action, and the only remedy is to dismiss the same."

TRIAL COURTS HAVE JURISDICTION TO REVIEW APPRAISAL REVIEW BOARD ORDERS IF A TAXPAYER HAS EXHAUSTED ITS ADMINSTRATIVE REMEDIES BY APPEARING BEFORE THE REVIEW BOARD.

Fort Bend Cent. Appraisal Dist. v. McGee Chapel Baptist Church, 611 S.W.3d 443 (Tex. App.—Houston [14th Dist.] 2020, no pet.).

In 2016, an appraisal district notified a church that it was removing the church's religious property tax exemption for tax years 2012-2016. The church timely protested the district's decision. The district asserted it had sent notices to the church regarding the date of the exemption hearing. The church claimed it never received the notices. As a result, the church failed to appear for the appraisal review board hearing. Because the church failed to appear for the hearing, the appraisal review board did not issue a ruling on the protest.

Shortly thereafter, the church filed a protest with the appraisal review board claiming it did not receive notice of the exemption hearing as allowed under section 41.411(a) of the Texas Tax Code. The appraisal review board scheduled a hearing on the church's section 41.411 protest. The church appeared at the hearing, and the appraisal review board denied the church's section 41.411 protest.

The church filed suit seeking review of both determinations. The district filed a plea to the jurisdiction, arguing the church failed to exhaust its administrative remedies prior to filing suit. The Houston Court of Appeals held that the trial court possessed subject matter jurisdiction over the church's section 41.411 protest because the church had exhausted its administrative remedies by appearing at the hearing. However, the court of appeals concluded that the trial court lacked subject matter jurisdiction over the church's exemption protest because the appraisal review board never issued a final order on the exemption protest, reasoning, "The ARB has not taken action on the merits of the exemption because McGee Chapel did not appear at the Exemption Protest Hearing and the ARB denied McGee Chapel's Section 41.411 protest without reaching the exemption issue. Because the ARB has yet to determine McGee Chapel's Exemption Protest, McGee Chapel has not exhausted its administrative remedies, and the issue is not ripe for judicial review under Chapter 42."

TIMELY PAYMENT OF TAXES DOES NOT GRANT AN OWNER AN INDEFINITE WINDOW OF TIME TO PROTEST APPRAISAL OF BUSINESS PERSONAL PROPERTY. OWNERS ARE REQUIRED TO FILE SECTION 25.25(D) MOTIONS TO CORRECT AND SECTION 41.411 LACK OF NOTICE PROTESTS PRIOR TO THE GENERAL FEBRUARY 1 DELINQUENCY DEADLINE, REGARDLESS OF WHETHER THE TAXES ACTUALLY BECOME DELINQUENT.

Harris County Appraisal Dist. v. IQ Life Sci. Corp., 612 S.W.3d 93 (Tex. App.—Houston [14th Dist.] 2020, no pet.)

A company owned business personal property in Harris County for three tax years. The company did not protest the appraised value of the business personal property for any of the tax years at issue, prior to the February 1 delinquency date of each year after the tax year. Instead, the company paid the exact amount shown on its property tax bills before the February 1 deadline. Years later, the company sought to protest the appraised value of its personal property pursuant to section 25.25(d), arguing it was entitled to correct the appraisal roll. It cited section 41.411, asserting Harris County Appraisal District failed to send notices of the appraised values of its personal property. The company filed suit in district court after the appraisal review board denied its protest. The appraisal district filed a plea to the jurisdiction, arguing the court lacked subject matter jurisdiction to hear Plaintiff's lawsuit because the company failed to timely exhaust its administrative remedies by protesting the appraised values or filing a section 25.25(d) motion prior to the February 1 delinquency date for each respective tax year. In essence, the appraisal district argued Plaintiff waited too long to protest the appraised value of its personal property, and the court lacked jurisdiction to hear the claim. The trial court denied the appraisal district's plea to jurisdiction. On appeal, the company argued that no deadline existed for it to file its section 25.25(d) motion because it had timely paid the taxes owed each year, therefore the statutory deadline – requiring a motion to be filed prior to the delinquency date – was never triggered. The 14th Court of Appeals rejected this argument, reasoning that "any motion made pursuant to section 25.25(d) must be filed before the date the yearly taxes on the subject land become delinquent." The court further explained that "construing section 25.25(d) so that it allows motions for substantive corrections to property taxes to be filed years, even decades after the appraisal rolls have become fixed, would lead to absurd results and is directly contrary to the legislature's intent." Regarding the company's section 41.411 lack of notice protest, the district argued the company's protest was untimely. In response, the company argued there was no deadline to file its protest because it never received the appraisal notices. Alternatively, the company argued its protest was timely because: (1) the statute at issue requires a property owner to file a protest "prior to the date the taxes on the property to which the notice applies become delinquent," and (2) the company timely paid the taxes for each year at issue, and therefore the taxes never became delinquent. The court rejected these arguments and held that section 41.44(c) and section 41.44(c-3) deadlines described the general February 1 delinquency date that immediately follows each tax year, and that it applies to both the date for filing protests and for payment of taxes.

A TRIAL COURT ABUSES ITS DISCRETION IF IT REQUIRES A TAXPAYER TO PRODUCE EVIDENCE IN DISCOVERY PERTAINING TO THE MARKET VALUE OF A PROPERTY IN A SUIT WHERE THE TAXPAYER HAS ONLY RAISED AN UNEQUAL APPRAISAL CLAIM.

In re APTWT, LLC, 612 S.W.3d 85 (Tex. App.—Houston [14th Dist.] 2020, no pet.).

The owner of an apartment complex filed suit against an appraisal district, claiming unequal appraisal. The appraisal district sought discovery and filed a motion to compel the property owner to produce various documents related to the purchase of the apartment complex, including all appraisals, sales documents, and closing statements arising out of the owner's purchase. The owner filed an interlocutory challenge, claiming that the trial court had abused its discretion by asking for documents irrelevant to the suit. The court of appeals reversed the trial court's order finding that the trial court abused its discretion because, in an unequal appraisal suit, the scope of discovery was limited to matters relevant to the owner's unequal appraisal claim. The court concluded, "evidence of market value of the subject property is not necessarily relevant in such an action."

HEIRS OF DECEASED TAXPAYER MAY NOT COLLATERALLY ATTACK A DELINQUENT TAX JUDGMENT ON THE GROUNDS THAT PUBLIC RECORDS EXISTED AT THE TIME OF JUDGMENT, DEMONSTRATING THAT PUBLICATION BY NOTIFICAITON WAS NOT APPROPRIRATE.

Mitchell v. Map Res., Inc., 08-17-00155-CV, 2020 WL 5793135 (Tex. App.—El Paso Sept. 29, 2020, no pet.).

In 1999, taxing authorities sued to foreclose tax liens on mineral interests. The authorities claimed they could not locate and personally serve all of the defendants. As a result, they cited several defendants by publication, i.e. the taxing authorities "served" the defendants by publishing notice of the lawsuit. The attorney for the taxing units testified in support of serving the defendants by publication, claiming the defendants were unknown and could not be located after a diligent inquiry. The tax delinquency case proceeded to non-jury trial, and the court issued a judgment foreclosing the defendants' interests. Shortly thereafter, those interests were sold at a sheriff's sale.

Fifteen years later, heirs of one of the defendant's filed suit against the purchasers of the mineral interests to set aside the tax judgment. The heirs claimed the 1999 tax judgment was void as to their relative because "there was a complete failure of service of citation" on the deceased defendant and as a result she was thereby due process. The heirs argued that citation by publication was deficient because the ancestor was alive and her address could have been easily discovered by searching public records, including various warranty deeds of record. In short, the plaintiffs argued the taxing authorities could have easily ascertained the address of their relative and served her in person, which plaintiffs argued due process required. On appeal, the El Paso Court of Appeals determined that the district court had jurisdiction over the defendant in the 1999 tax suit by service by publication. The court ruled the heirs could not collaterally attack the 1999 judgment with extrinsic evidence but could only attack based on the testimony and evidence presented to the court.

NO TAX SITUS EXISTS IN A COUNTY FOR TRUCKS THAT SPEND ONLY A FEW HOURS TO A FEW DAYS IN A COUNTY. THE FACT THAT A PARENT CORPORATION OWNS A FACILITY IN A COUNTY DOES NOT PROVIDE GROUNDS FOR SITUS OF PROPERTY OWNED BY ITS SUBSIDIARY.

Dallas Central Appraisal District v. National Carriers, Inc., No. 05-18-01520-CV, 2020 WL 2124178 (Tex. App.–Dallas, May 5, 2020, no pet.).

A trucking company based in Kansas owned a facility in Dallas County which it used to recruit new drivers, provide orientation and safety information for truck drivers, provide administration and perform some light maintenance for trucks. One of its subsidiaries, also based in Kansas, owned trucks that drove irregular routes across the United States. Individual trucks stopped in Dallas County for a few hours up to a few days. The appraisal district claimed it had the right to tax the portion of the truck fleet that moved through Texas in Dallas County because those trucks cumulatively were located in Dallas County "with such a permanence that it became part of the general mass of property within the boundaries of the taxing authority." In support of its position, the appraisal district relied upon a case involving crude oil stored in tanks while awaiting transportation within the state. The court found the analogy to be "inapt" because individual trucks are distinguishable from an "undifferentiated mass of oil [that is] continuously present in [a] county." Given the lack of any permanent presence of any of the individual trucks, the county could not claim tax situs for them. Further, the court ruled that parent entities and their subsidiaries are separate persons, so the fact that a parent entity owned property in a county is irrelevant as to whether the property of its subsidiary had taxable situs in the county.

THE FAILURE TO RAISE TIMELY FILING OF AN OPEN SPACE LAND VALUATION APPLICATION BEFORE AN APPRAISAL REVIEW BOARD PRECLUDED AN APPEAL TO DISTRICT COURT.

Z Bar A Ranch, LP v. Tax Appraisal District of Bell County, No. 03-18-00517-CV, 2020 WL 1932908 (Tex. App.–Austin, April 22, 2020, no pet.)

This case involves much conflicting testimony by the taxpayers both at the appraisal review board and at trial. The court of appeals in reviewing the case found that the taxpayers testified before the appraisal review board that they had not filed a timely open space land valuation for the property after its acquisition. (The property had a long-standing history of open space valuation but new owners are required to apply for the valuation. Appraisal districts are not required to send new owners an application or to remind them to file an application). On appeal in district court, they changed their testimony to state that they had filed an application on a timely basis and that the testimony before the appraisal review board was in error. They relied upon the *de novo* trial provisions of the Tax Code for their ability to do so. The court noted that the taxpayers before the appraisal review board only argued that the open space land valuation should have been carried over from the prior owner and the failure of the appraisal district to notify them of its removal deprived them of their rights. The court noted the testimony of one of the owners at the hearing where he stated that "we" had not filed an application. Based upon the record, the appellate court found that the taxpayers had failed to exhaust their administrative remedies by raising the issue of a timely filing of an open space land application with the district and the district's denial of it without notice. In doing so, the court found that the trial court lacked jurisdiction to try the case.

John Brusniak
Chris Arnell
Brusniak Turner Fine LLP
17480 Dallas Parkway, Suite 210
Dallas, Texas 75287
(214) 506-1073
john@TexasPropertyTaxAttorneys.com
chris@TexasPropertyTaxAttorneys.com

Overview of Outbound International Tax Rules

HBA Tax Section

John T. Woodruff

02.17.21

Subpart F Income

Subpart F – Applicability

- Every U.S. shareholder of a controlled foreign corporation (“CFC”) who owns CFC stock on the last day of the year in which it is a CFC shall include:
  - his pro rata share of the CFC's subpart F income, and
  - the § 956 amount with respect to such shareholder.
- A “U.S. Shareholder” for this purpose is a U.S. person who owns 10 percent or more of the voting power *or value* of the foreign corporation’s stock.
- A CFC is a foreign corporation if more than 50 percent of the voting power or value of the stock is owned by United States shareholders *on any day* during the taxable year.
- Both of the foregoing definitions are determined with the application of attribution principles under Sec. 958.

Subpart F Income – Definition

- Subpart F income means the sum of:
  - insurance income (as defined in section 953),
  - foreign base company income (as determined in section 954), and
  - Certain other categories including boycott income and income from countries with which the U.S. does not have diplomatic relations.
- Foreign base company income means the sum of:
  - foreign personal holding company income (“FPHCI”);
  - foreign base company sales income (“FBCSaI”); and
  - foreign base company services income (“FBCSeI”).

Subpart F Income – Exclusions

- Subpart F income does not include United States effectively connected income (unless exempt or subject to reduced rate of tax under a treaty). § 952(b).
- Subpart F income is limited to current earnings and profits. § 952(c)(1)(A).
- Certain prior year deficits may be taken into account, including deficits of certain members of the same chain of corporations. § 952(c)(1)(B).
- In addition, if subpart F income is reduced by reason of the earnings and profits limitation, any excess of the earnings and profits of such corporation for any subsequent taxable year over the subpart F income is recharacterized as subpart F. § 952(c)(2).

Subpart F Income – Exclusions

- De minimis rule. If the sum of foreign base company income and the gross insurance income is less than the lesser of-
  - 5 percent of gross income, or
  - $1,000,000,

no part of the gross income for the taxable year is treated as foreign base company income or insurance income.

- Full inclusion rule. If the sum of the foreign base company income and the gross insurance income exceeds 70 percent of gross income, the entire gross income shall be treated as foreign base company income or insurance income (as appropriate).

- High Tax Exception. Foreign base company income and insurance income shall not include any item of income received by a CFC if such income was subject to a foreign effective rate of income tax greater than 90 percent of the maximum corporate tax rate.

Subpart F Income – FPHCI

- FPHCI includes:
  - Dividends, interest, royalties, rents, and annuities;
  - The excess of gains over losses from the sale or exchange of certain kinds of property, including:
    - Property which gives rise to FPHCI;
    - Interests in a trust, partnership, or REMIC, or
    - Property which does not give rise to any income.
      - However, gains and losses from the sale or exchange of capital assets (defined in sec. 1221(a)(1)) are not taken into account.

Subpart F Income – FPHCI

- FPHCI includes:
  - The excess of gains over losses from transactions in any commodities, with certain exceptions.
  - Foreign currency gains.
  - Income from notional principal contracts.
  - Payments in lieu of dividends which are made pursuant to a securities lending arrangement.
  - Personal service contracts.

Subpart F Income – FPHCI Exceptions

- <u>Active Rents</u>:
  - FPHCI does not include rents and royalties which are derived in the active conduct of a trade or business and which are received from a person other than a related person.
  - Rents are considered to be derived in the active conduct of a trade or business if such rents are derived by the CFC from leasing:
    - Property that the lessor has manufactured or produced, or has added substantial value to;
    - Real property for which the lessor regularly performs active and substantial management and operational functions while the property is leased;
    - Property that is leased as a result of marketing functions performed by such lessor, if the lessor maintains and operates an organization in such country.

Subpart F Income – FPHCI Exceptions

- Active Royalties:
  - Royalties are derived in the active conduct of a trade or business if derived by the CFC from licensing-
    - Property that it has developed, created, or produced, or acquired and added substantial value to;
    - Property that is licensed as a result of the performance of marketing functions by such licensor, if the licensor maintains and operates an organization in such foreign country.

Subpart F Income – FPHCI Exceptions

- Same Country Rents and Royalties:
  - FPHCI does not include rents or royalties if-
    - The payor is a related corporation; and
    - The rents or royalties are for the use of property within the same country where the recipient CFC is organized.
  - Relatedness is defined under section 954(d)(3) as ownership of more than 50 percent of the voting power or value of stock.
  - Exception. Rents or royalties may not be excluded from FPHCI of the recipient to the extent that such payment was deductible against subpart F income of the payor.

Subpart F Income – FPHCI Exceptions

- Same Country Dividends and Interest:
  - FPHCI does not include dividends and interest received from a related corporation which:
    - is organized under the laws of the same foreign country in which the CFC is organized, and
    - has a substantial part of its assets used in its trade or business located in such same foreign country.
  - Relatedness defined under section 954(d)(3).
  - This exception does not apply to dividends out of e&p earned prior to the shareholder's ownership.

Subpart F Income – FPHCI Exceptions

<u>CFC Look-Thru Rule</u>:

- Dividends, interest, rents, and royalties received by a CFC from a related CFC are not be treated as FPHCI if allocable to income which is neither subpart F nor ECI.
- This exception does not apply to the extent such payment creates (or increases) a deficit which may reduce the subpart F income of the payor.
- The CFC look-through rule <u>applies to tax years beginning before January 1, 2026</u>.

Subpart F Income – FPHCI Exceptions

- Partnership Sale Look-Thru Rule:
  - If a CFC sells an interest in a partnership in which it is a 25-percent owner, the CFC is treated as selling a proportionate share of the partnership's assets.
  - The term "25-percent owner" means a CFC which owns directly 25 percent or more of the capital or profits interest in a partnership.

Subpart F Income – FBCSaI

Foreign Base Company Sales Income:

- Income derived in connection with the purchase of property from a related person and its sale to any person, the sale of property to any person on behalf of a related person, the purchase of property from any person and its sale to a related person, or the purchase of property on behalf of a related person where-
  - the property which is purchased (or sold) is manufactured, produced, grown, or extracted outside the country where the CFC is organized, and
  - the property is sold for use outside such foreign country, or, in the case of property purchased on behalf of a related person, is purchased for use outside such foreign country.

Subpart F Income – FBCSaI

- Property sold by a CFC will generally be considered to be the same property that was purchased regardless whether it is sold in the same form in which it was purchased or as a component part of a manufactured product.

Subpart F Income – FBCSaI

<u>Exceptions</u>:

- The personal property purchased by the CFC is substantially transformed prior to sale.
  - If purchased property is used as a component part of property which is sold, the sale will be treated as the sale of a manufactured product if the assembly or conversion of the component parts into the final product involves activities that are substantial in nature.
  - Under a safe harbor, assembly will be considered to constitute manufacturing if the conversion costs account for 20 percent or more of the total cost of goods sold.

Subpart F Income – FBCSaI

Exceptions, cont'd:

- The CFC makes a substantial contribution to the manufacturing of the property.
- Regulations approve of the consideration of the following activities in determining whether a CFC made a substantial contribution to manufacturing:
  - Oversight and direction of the activities or process pursuant to which the property is manufactured, produced, or constructed.
  - Activities that are considered in, but that are insufficient to satisfy, the substantial transformation test.

Subpart F Income – FBCSaI

- Exceptions, cont'd:
    - Material selection, vendor selection, or control of the raw materials, work-in-process or finished goods.
    - Management of manufacturing costs or capacities.
    - Control of manufacturing related logistics.
    - Quality control.
    - Developing, or directing the use or development of, product design and design specifications and intellectual property.

Subpart F Income – FBCSaI

- Branch Rule: In situations in which the carrying on of activities by a controlled foreign corporation through a branch or similar establishment outside the country of incorporation of the controlled foreign corporation has substantially the same effect as if such branch or similar establishment were a wholly owned subsidiary corporation deriving such income, the income attributable to the carrying on of such activities of such branch shall be treated as income derived by a wholly owned subsidiary of the CFC for purposes of applying the FBCSaI rules.

Subpart F Income – FBCSeI

Foreign Base Company Services Income:

- Income derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services which-
  - are performed for or on behalf of any related person, and
  - are performed outside the country under the laws of which the CFC is organized.

Subpart F Income – FBCSeI

Substantial Assistance:

- In addition, FBCSeI includes assistance furnished by a related person to a CFC, including direction, supervision, services, know-how, financial assistance, and equipment, material, or supplies.
- Under Notice 2007-13, IRS limited the types of activities that constitute substantial assistance to assistance provided by a related U.S. person that satisfies an objective cost test.
- The cost test will be satisfied if the cost to the CFC of the assistance equals or exceeds 80 percent of the total cost to the CFC of performing the services. The substantial contribution/principal element test is eliminated.

Subpart F Income – Investment in U.S. Property

- Section 956 provides that if a CFC makes certain investments in U.S. property, its U.S. shareholders are required to include an amount of the CFC’s earnings and profits in income equivalent to the lesser of its earnings or its tax basis in U.S. property.
- The amt of the CFC’s earnings and profits taken into account is the lesser of:
  - The average tax basis of its U.S. property (reduced by liabilities to which such it is subject) as of the close of each quarter over previously taxed income; or
  - Such shareholder's pro rata share of the applicable earnings of such controlled foreign corporation.
- Applicable earnings means the sum of a CFC’s current and accumulated profits, reduced by distributions made during the year and by previously taxed income.
  - Distributions made by a CFC for any taxable year are considered first made out of earnings and profits other than § 952(b) earnings and profits (U.S. source ECI).

Subpart F Income – Investment in U.S. Property

- U.S. property is defined as including:
  - tangible property located in the United States;
  - stock of a domestic corporation;
  - an obligation of a United States person; or
  - any right to the use in the United States certain intangible property which is acquired or developed by the controlled foreign corporation for use in the United States;
  - Certain direct and indirect pledges and guarantees;
    - Often a source of contention in financing arrangements.

Subpart F Income – Investment in U.S. Property

- Exclusions from U.S. Property (partial):
  - Certain obligations of the U.S.;
  - Property located in the U.S. which is purchased for export;
  - Stock or obligations of a domestic corporation which is neither a U.S. Shareholder of the CFC nor owned 25 percent or more by United States shareholders of the CFC;
  - An amount of assets of the CFC equal to the earnings and profits excluded from subpart F income under section 952(b).

Subpart F Income – Investment in U.S. Property

New Section 956 Regulations:

- Newly-issued regulations provide that 956 amounts are reduced to the extent that the U.S. shareholder would receive a section 245A deduction if it received a distribution of the 956 amount.
- Under these regulations, due to the broad applicability of section 245A to distributions, a corporate U.S. shareholder will often not realize a 956 inclusion.
- However, section 956 will continue to apply without change to U.S. shareholders other than corporate U.S. shareholders.

Subpart F Income – Investment in U.S. Property

New Section 956 Regulations:

- The new section 956 regulations alleviate many of the concerns of U.S. corporate borrowers arising from indirect investments of U.S. property resulting from a pledge of CFC collateral or more than 65% of the shares of a CFC. Potentially allows corporate borrowers to increase borrowing capacity without creating a tax issue.
- On the other hand, there are situations in which a distribution of profits from a CFC to its U.S. corporate shareholder would not benefit from the section 245A DRD, including:
  - Hybrid arrangements;
  - Section 246(c) holding period not met;
  - U.S. source earnings and profits.
- Treas. Reg. § 1.960-2(b)(1) provides that no foreign income taxes are deemed paid under section 960 with respect to a section 956 inclusion.

GILTI

Determining GILTI

- A U.S. shareholder of a CFC must include in income its share of the global intangible low-taxed income of the CFC.

- GILTI is defined as the excess of a shareholder’s net CFC tested income for such taxable year, over such shareholder's net deemed tangible income return for such taxable year.

$$\left.\begin{array}{l}\text{CFC Tested Income} \\ -\ \text{CFC Tested Loss}\end{array}\right\}\ \text{Net CFC Tested Income}$$

- <u>Net Deemed Tangible Income Return (“DTIR”)</u>

= Global Intangible Low-Taxed Income (“GILTI”)

Determining GILTI

- Net CFC tested income means the excess of—
  - the *aggregate* of such shareholder's pro rata share of tested income of each CFC, over
  - the *aggregate* of such shareholder's pro rata share of the tested loss of each CFC.

- Tested Income means the CFC’s gross income (determined without regard to excluded income) less properly allocable deductions, including taxes.

- Tested Loss means the excess of deductions (including taxes) properly allocable to CFC’s gross income over CFC Tested Income.

Determining GILTI

- Income excluded from Tested Income:
  - Effectively connected income unless excluded from U.S. tax by treaty;
  - Gross income taken into account in determining subpart F;
  - Gross income excluded from subpart F by reason of the high tax exception;
  - Dividends received from a related person; and
  - Foreign Oil and Gas Extraction Income (FOGEI).

Determining GILTI

- Excluded High Tax Exception Income

  - With the reduction in the U.S. corporate tax rate to 21%, the application of the high tax exception will be much more prevalent (.9*21%=18.9%).

  - *However, if the Biden proposal becomes law, corporate tax rate will increase to 28%, resulting in less high tax exception income.*

Determining GILTI

- Apportionment of Deductions
  - For purposes of determining tested income and tested loss, the gross income and allowable deductions of a CFC are determined under the rules of §1.952-2, which generally determines gross income and loss as if the CFC were a domestic corporation.
  - Deductions of a CFC must be allocated and apportioned to gross tested income under the principles of section 954(b)(5). This section determines net FBCI by apportioning expenses to various classes of gross FBCI, such as FBCSaI, FSCSeI, general category FPHCI and passive category FPHCI.
  - § 1.951A-2(c)(2).

Determining GILTI

- Net DTIR is defined as the excess of—
  - 10% of the aggregate of such shareholder's pro rata share of QBAI of the CFC, over
  - Interest expense taken into account in determining net CFC tested income to the extent interest income attributable to such expense is not taken into account in determining such shareholder's net CFC tested income.
  - The Code does not specify what interest income is “attributable to” interest expense. This language could be interpreted to require a tracing approach.

Determining GILTI

- Net Interest Expense for DTIR Purposes
  - The Treasury Department determined that a netting approach to specified interest expense was appropriate. Therefore, regulations provide that a U.S. shareholder's specified interest expense is the excess of its aggregate share of the tested interest expense of each CFC over its aggregate pro rata share of the tested interest income of each CFC.

  - Tested interest expense and tested interest income are generally defined by reference to all interest expense and interest income that is taken into account in determining a CFC's tested income or tested loss.
  - Treas. Reg. §§ 1.951A-4(b)(1) and (2).

Determining GILTI

- Definition of QBAI
  - QBAI means the average of such corporation's aggregate adjusted bases as of the close of each quarter of such taxable year in specified tangible property used in a trade or business of the corporation, and of a type with respect to which a depreciation deduction is allowable.
  - Specified tangible property means tangible property used in the production of tested income. However, Treas. Reg. § 1.951A-3(b) provides that a tested loss CFC has no QBAI.
  - QBAI basis is determined by using the ADS system (§ 168(g)), and by allocating the depreciation deduction ratably to each day during the taxable period to which such depreciation relates.

Determining GILTI

- Determining a Shareholder’s Share of Tested Items
  - Section 952(c)(1)(A) is applied by increasing the earnings and profits of the controlled foreign corporation by the tested loss of such corporation.
  - Treasury interpreted this provision to mean that any income described in § 952(a) is “taken into account in determining subpart F income” regardless of whether the § 952(c) limitation applies.
  - Concomitantly, gross income of CFC does not include any item of gross income that results in the recharacterization of earnings and profits as subpart F income of the CFC under section 952(c)(2).

Determining GILTI

- Example.

  - In year 1, FS, a CFC, has passive FPHCI of $100x, a general category loss in FOGEI of $100x, and e&p of $0. In Year 2, FS has general category gross income of $100x and e&p of $100x.

  - As a result of the e&p limitation, FS has no subpart F income in Year 1. However, gross income for GILTI purposes includes any item of gross income excluded from the subpart F income under section 952(c)(1). Therefore, the $100x FPHCI of FS in Year 1 is excluded from gross tested income and FS has no gross tested income in Year 1.

  - In Year 2, under section 952(c)(2), FS's general category earnings and profits ($100x) in excess of its subpart F income ($0) are recaptured as passive subpart F income. Therefore, FS has passive category subpart F income of $100x in Year 2. However, gross income for GILTI purposes does not include income that results from the recharacterization of earnings and profits as subpart F income under section 952(c)(2). Therefore, FS has $100x of general category gross tested income in Year 2.

Determining GILTI

- Determining a Shareholder’s Share of Tested Items
  - A shareholder’s pro rata share of tested income, tested loss and QBAI is determined in the same manner as section 951(a)(2) applies to subpart F income.
  - A United States shareholder's pro rata share of any CFC tested item is translated into United States dollars using the average exchange rate for the CFC inclusion year of the controlled foreign corporation.
  - A person is treated as a United States shareholder of a CFC for a taxable year if such person owns stock in the CFC on the last day in the taxable year on which such foreign corporation is a CFC.

Determining GILTI

- Determining Pro Rata Shares of Income and Loss:
  - Section 951(a)(2) principles determine a shareholder's pro rata share of subpart F income by treating such income as if it had been distributed pro-rata to its shareholders on the last day of its tax year during which it is a CFC.
  - A shareholder's pro rata share of the tested loss is determined by treating tested loss as if were an amount of current earnings and profits and applying § 951(a)(2).
  - Generally, the hypothetical distribution of tested loss is made solely with respect to the common stock of the tested loss CFC.

Determining GILTI

- Determining Pro Rata Shares of QBAI:
  - A United States shareholder's pro rata share of the QBAI of a tested income CFC generally bears the same ratio to the total QBAI as the United States shareholder's pro rata share of the tested income bears to total tested income.
  - However, QBAI in excess of 10 times tested income is allocated solely to common stock.

Determining GILTI

- Applying Collateral Rules:
  - GILTI is treated in the same manner as an amount included in Subpart F income for purposes of applying a number of sections of the Code, including (in part):
    - Section 959, excluding earnings and profits previously subject to tax pursuant to the subpart F rules from further taxation on remittance.
    - Section 961, which increases a U.S. Shareholder’s basis in a CFC by the amount of subpart income it recognized, but has not distributed.

Determining GILTI

- Applying Collateral Rules:
    - Section 962, allowing an individual U.S. Shareholder to elect to be treated as a corporation.
    - Section 1248(d)(1), excluding previously-taxed income from treatment as a 1248 dividend on a disposition of CFC stock.
- IRS was also granted authority to treat GILTI as if it were subpart F income for the purposes of applying certain other provisions. In this regard, regulations provide that a GILTI inclusion amount is treated in the same manner as subpart F for net investment income tax purposes (§ 1411).

Determining GILTI

- Reallocation of GILTI to CFC's:
  - The portion of GILTI which is treated as being with respect to a CFC is:
    - in the case of a CFC with no tested income, zero, and
    - in the case of a CFC with tested income, the portion of GILTI which bears the same ratio to such GILTI as—
      - The United States shareholder's pro rata amount of the tested income of such CFC, bears to
      - The aggregate amount of such shareholder's pro rata share of the tested income of all CFC's.

Determining GILTI

- *Example:* USP, a domestic corporation, owns all of the stock of three controlled foreign corporations, CFC1, CFC2, and CFC3. In Year 1, CFC1 has tested income of $100x, CFC2 has tested income of $300x, and CFC3 has tested loss of $50x. Neither CFC1 nor CFC2 has QBAI.

- In Year 1, USP has a GILTI inclusion amount of $350x ($100x + $300x - $50x). The aggregate amount of USP's pro rata share of tested income from CFC1 and CFC2 is $400x ($100x + $300x). The portion of USP's GILTI inclusion allocable to CFC1 is $87.50x ($350x x $100x/$400x) and the amount allocable to CFC2 is $262.50x ($350x x $300x/$400x). No GILTI inclusion amount is allocable to CFC3 because it is a tested loss CFC.

- The portion of the GILTI inclusion allocated to a tested income CFC is translated into the functional currency of the tested income CFC using the average exchange rate for the CFC inclusion year.

Determining GILTI

- Basis Reductions for Tested Losses:
  - In determining a U.S. shareholder's net CFC tested income, the U.S. shareholder's pro rata share of a tested loss of one CFC may offset the shareholder's pro rata share of tested income of another CFC.
  - Under the statute, use of a tested loss does not reduce the U.S. shareholder's basis in the stock of the tested loss CFC, increase the stock basis of the tested income CFC, or affect the earnings and profits of either the tested loss CFC or the tested income CFC.

Determining GILTI

- Basis Reductions for Tested Losses:
  - Under proposed regulations, Treasury had determined that the lack of adjustments to stock basis of a tested loss CFC could lead to inappropriate results. In the proposed regulations, Treasury suggested that if a U.S. shareholder's basis in the stock of the tested loss CFC is not reduced to reflect the use of the tested loss to offset tested income taken into account by the U.S. shareholder, the U.S. shareholder could recognize a duplicated loss — either through the recognition of a loss or the reduction of gain — if the stock of the tested loss CFC was disposed of.
  - However, this portion of the proposed regulations was not adopted in the final regulations.

Determining GILTI

- Anti-Abuse: IRS was directed to issue such regulations or other guidance as it determined appropriate to prevent the avoidance of the purposes of the GILTI rules, including regulations or other guidance which provide for the treatment of property if—
  - (A) such property is transferred, or held, temporarily, or
  - (B) the avoidance of the purposes of this paragraph is a factor in the transfer or holding of such property.

Determining GILTI

- Disregard of basis in temporarily held property.
  - If a tested income CFC acquires tangible property with a principal purpose of reducing the GILTI inclusion amount of a U.S. shareholder, and the tested income CFC holds the property temporarily but over at least the close of one quarter, the specified tangible property is disregarded in determining the acquiring CFC's average adjusted basis in determining QBAI.
  - Specified tangible property held by the tested income CFC for less than a twelve month period that includes at least one quarter close is treated as temporarily held and acquired with a principal purpose of reducing GILTI.
  - Treas. Reg. § 1.951A-3(h)

Biden GILTI Proposals

- Increase of corporate tax rates to 28% would narrow the application of the high tax rule.
- Double the corporate tax rate on GILTI income from the current 10.5% to 21%.
- Eliminate the exemption for QBAI. This effectively turns the GILTI provisions in a full tax inclusion rule.
- Compute GILTI tax (and related foreign tax credits) on a country-by-country basis, rather than using a worldwide average.

John Woodruff
Shareholder

jwoodruff@polsinelli.com
713.374.1651
1000 Louisiana Street
Suite 6400
Houston, TX 77002
polsinelli.com

YEAR-END 2020 LEGISLATIVE AND IRS DEVELOPMENTS FOR BENEFIT PLANS

By Felicia A. Finston, William M. Fisher, and Linda A. Wilkins
Wilkins Finston Friedman Law Group LLP
January 5, 2021

CONSOLIATED APPROPRIATIONS ACT CHANGES

The Consolidated Appropriations Act, 2021 (the "**Act**"), signed into law by President Trump on December 27, contains numerous provisions that impact employee benefit plans. Here is a summary of the most notable provisions.

Health and Dependent Care FSAs

Under the Act, health flexible spending arrangements ("**FSAs**") and dependent care FSAs may be amended (but are not required to be amended) to:

- Allow participants to carry over any unused balance from the plan year ending in 2020 to the plan year ending in 2021, as well as from the plan year ending in 2021 to the plan year ending in 2022. Note, the Act's relief expands upon more limited relief authorized by the IRS in Notice 2020-29, which allowed health FSAs (and not dependent care FSAs) to be amended to allow for a carryover of up to 20% of the annual maximum contribution election, which for 2020 meant a carryover limited to $550. For more information about the prior IRS relief, see our Client Alert at: http://www.wifilawgroup.com/clientalertmay152020.html;

- Provide an extended grace period of up to 12 months after the end of each of the plan years ending in 2020 and in 2021, as opposed to the traditional 2½ month grace periods allowed by statute. This also expands on the relief of IRS Notice 2020-29, which allowed for an extended grace period ending on December 31, 2020 for any plan year or grace period ending during 2020. However, it is still the case that an FSA may not have both a grace period and a carryover provision in effect during the same plan year. In other words, an FSA can either allow a carryover of unused amounts to the next plan year to be used for claims during that plan year or it can provide a grace period during which claims incurred during the first 2½ months of the next plan year may be reimbursed from the prior year's FSA balance; and

- Permit prospective mid-year election changes during the plan year that ends in 2021, without requiring a change in status event. This extends by one year the relief previously offered by IRS Notice 2020-29.

Furthermore, a health FSA may be amended to allow employees who terminate employment in 2020 or 2021 to continue receiving reimbursements from unused benefits and contributions for expenses incurred through the end of the year (plus any applicable grace period) in which they were terminated without running afoul of the risk sharing requirements applicable to health FSAs. It is unclear from the statute exactly how this rule works; i.e. whether the reimbursements can only be made from the participant's remaining contributions that have already been made to the health FSA via salary reduction or from the unused annual election amount, which must be uniformly available at any time under existing rules. If the rule applies to the unused annual election amount, it would eliminate the need to offer COBRA coverage for those health FSA participants who terminate with a positive balance, and would mean the employer would be responsible for funding those reimbursements that exceed the participant's account balance but are less than the participant's annual election amount. If that is the proper interpretation, it is unlikely that many employers would adopt this optional amendment because the financial burden would fall on them alone. Further IRS guidance on this matter would be helpful.

Finally, a dependent care FSA may be amended to allow targeted relief to employees who have a dependent reach age 13 during the COVID pandemic, effectively allowing a carryover of an unused balance that may be used to reimburse dependent care expenses incurred up to age 14 to be reimbursed.

Takeaway: Plan sponsors should determine whether they wish to implement all or a portion of this optional relief under the Act. If so, they should communicate the chosen relief to plan participants and make sure to operate the plans consistent with such relief. Retroactive plan amendments to implement the chosen relief must generally be adopted by December 31, 2021, although different deadlines may apply to fiscal year plans. When drafting such amendments, care must be taken to properly reflect the terms of any of the more limited relief that may have been implemented during 2020 pursuant to IRS Notice 2020-29, which has the same amendment deadline. If adopting any of the relief offered by the Act, plan sponsors should consider taking steps to limit their financial exposure, including limiting the number of mid-year election changes that will be permitted and prohibiting reductions in pre-tax FSA elections or carryovers of unused contributions or balances that would result in underfunding of reimbursements that have already been made.

Tax Exclusion for Student Loan Debt Paid by Employers

The Act provides that, if an employer pays any student loan debt on behalf of its employees, these payments will be non-taxable as educational assistance program "fringe benefits." The maximum annual exclusion for all educational assistance programs is $5,250. This rule applies to payments made between March 27, 2020 and December 31, 2025.

Relaxation of Partial Termination Rules

Plan sponsors have been justly concerned that the number of lay offs made on account of the pandemic may have triggered a partial termination of their qualified plans in 2020, which would require full vesting of the affected participants. However, the Act relaxes the partial termination rules by extending the period used to determine whether such a termination has occurred, in effect allowing new hires/rehires who become covered by a plan by March 31, 2021 to be taken into account to offset terminated participants. Specifically, no partial termination will occur during any plan year which includes the period beginning on March 13, 2020 and ending on March 31, 2021 if the number of active participants covered by the plan on March 31, 2021 is at least 80% of the number of active participants covered on March 13, 2020.

NEW IRS GUIDANCE

Clarifications to SECURE Act Provisions re Long-Term Part-Time Employees

The Internal Revenue Service has issued new guidance addressing the impact of the pandemic on employee benefit plans and reviewing SECURE Act requirements. Here is a summary:

IRS Notice 2020-68 (at https://www.irs.gov/pub/irs-drop/n-20-68.pdf) provides guidance on implementing the new 401(k) plan eligibility rules that require certain long-term part-time employees ("**LTPTEs**") to be allowed to make elective deferrals, even if they do not complete a traditional service requirement of 1000 hours of service in a year. Under the SECURE Act, an employee who completes at least 500 hours of service in three consecutive 12-month periods, starting with plan years beginning after December 31, 2020, cannot be excluded from the plan based solely on failure to complete 1,000 hours of service in a year. So long as the employee is age 21 and not in another excluded class of employees, the employee must be permitted to make elective deferrals once they have completed at least three consecutive years with at least 500 hours of service, which at the earliest will be the first plan year beginning after December 31, 2023. See our Client Alert regarding the SECURE Act at:
http://www.wifilawgroup.com/clientalertjanuary142020.html.

Takeaway: Plan sponsors must begin to track hours worked by LTPTEs for plan years beginning in 2021 and retain that information in future years so they can determine whether plan eligibility is met under this provision for any plan years starting after December 31, 2023. Also, plan sponsors must amend their plans to comply with this, as well as other SECURE and CARES Act requirements, by the last day of the first plan year beginning on or after January 1, 2022 (2024 for governmental plans).

The SECURE Act does not require plans to provide employer contributions, such as matching contributions, to LTPTEs who meet the service requirement and must be allowed to make elective deferrals. However, if an employer chooses to amend its 401(k) plan and provide employer contributions to LTPTEs, it may incur an unexpected recordkeeping burden. The Notice clarifies that years of service for purposes of vesting in any employer contributions made to LTPTEs must include all years in which the employee was at least age 18 and completed at least 500 hours of service. This differs from the rules for determining eligibility of LTPTEs to make elective deferrals in three ways: for vesting purposes, there must be taken into account years before 2021, years between ages 18 and 21, and nonconsecutive years.

Takeaway: Plan sponsors should be aware that they will be inviting a potentially significant recordkeeping burden if they decide to amend their 401(k) plans to provide employer contributions to LTPTEs and subject those contributions to a vesting schedule. Before making this choice, employers should visit with their third-party recordkeepers concerning the feasibility of collecting and maintaining the information needed to track vesting, including for periods of service before 2021 for which the plan sponsor (understandably) may not have been tracking/retaining such information.

Extended Permission for Remote Notarization

Under IRS Notice 2021-3, remote notarization of spousal consent forms will continue to be permitted through June 30, 2021. This is an extension of the relief from the physical presence requirement originally included in IRS Notice 2020-42 and described in our Client Alert at http://www.wifilawgroup.com/clientalertjune32020.html.

The Department of Justice Announces First Guilty Pleas in Conservation Easement Transactions

By Michael A. Villa, Jr.

On Monday, December 21, 2020, Stein and Corey Agee of Atlanta, Georgia entered guilty pleas in federal court to conspiracy charges related to their roles in syndicated conservation easement transactions. These are the first guilty pleas related to the continuing IRS and Department of Justice criminal investigations across the country pertaining to easement transactions.

Stein and Corey Agee were partners at the Atlanta accounting firm AgeeFisherBarrett, LLC. They each pleaded guilty to one count of conspiracy to defraud the United States, an offense that carries up to five years in prison.

Most importantly, a plea such as this generally indicates the Agees will be cooperating with the United States in their ongoing investigations.

The government alleged the Agees marketed, promoted and sold investments in a tax shelter that took advantage of a popular land conservation benefit. According to the government, at the core of the transactions, taxpayers were told that for every dollar invested in the scheme, investors would receive more than $4 in charitable tax deductions. The government also alleged the Agees, and others, fraudulently backdated transaction documents for some taxpayers.

The Department of Justice press release is HERE .

For any questions on this or any other tax-related matter, please feel free to contact Mike Villa at (214)749-2405 or mvilla@meadowscollier.com.

Originally published as an MC Talks Tax article on The Meadows Collier Tax Blog; republished with permission.

Texas Tax Quarterly Update

4th Quarter 2020

Live Broadcast January 14, 2021

This outline 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.

Instructor

GORDON MARTENS
Attorney | Martens, Todd & Leonard

Gordon Martens, trial attorney, is an associate with Martens, Todd & Leonard, a boutique tax litigation law firm located in downtown Austin, Texas. He and other members of his law firm limit their practices to Texas tax controversies and litigation. Mr. Martens represents clients in administrative proceedings before the Texas Comptroller's office, the Texas State Office of Administrative Hearings, and in Texas state courts.

Mr. Martens is licensed to practice law in Texas and Louisiana. He has several years' experience representing clients in state and local tax controversies, with a focus on the energy, construction, and technology industries.

Mr. Martens is a member of the State Bar of Texas Tax Section and the Louisiana State Bar Association. Mr. Martens earned his bachelor's degree from The University of Texas at Austin, with honors. Mr. Martens earned his J.D. degree from the University of Houston Law Center with highest honors.

Mr. Martens may be reached by email at gmartens@textaxlaw.com or by telephone at (512) 542-9898.

Table of Contents

Introduction

These materials cover critical recent and ongoing developments in Texas sales tax and Texas franchise tax during the fourth quarter of 2020. They include the Comptroller's extensive changes to his franchise tax apportionment rule and legislation pre-filed in the 2021 legislative session, along with other important Texas sales tax and franchise tax developments.

The TXCPA provides these materials to its participants in its Texas Taxes: Quarterly Updates webcasts. Members of the TXCPA may attend the quarterly webinars free of charge. The TXCPA has agreed to provide access to the quarterly webinars to members of the Tax Section of the State Bar for a nominal charge. The sessions covering 2021 developments are scheduled to occur on the following dates from 12:00 p.m. through 1:00 p.m.:

Period Covered	Webcast Date
First Quarter 2021	Apr. 8, 2021
Second Quarter 2021	Jul. 8, 2021
Third Quarter 2021	Oct. 14, 2021
Fourth Quarter 2021	Jan. 13, 2022

Attendees can register through the TXCPA website at https://www.tx.cpa/education/cpe.

I. Franchise Tax

COVID-19 Deadline Relief

Extended Due Date. On April 2, 2020, the Comptroller announced that the due date for Report Year 2020 Texas franchise tax reports is automatically extended for all taxpayers to July 15, 2020.[1] The automatic extension includes both the report deadline and the payment deadline. The Comptroller extended the franchise tax deadline "to be consistent with the Internal Revenue Service" which has extended certain federal income tax filing deadlines to July 15, 2020.[2] The Comptroller's press release explained the rationale for extending the franchise tax deadline:

> "We recognize that the information aggregated from taxpayers' federal tax returns comprises the building blocks for their Texas franchise tax returns," Hegar said. "In addition to coping with the unprecedented impacts of the growing pandemic, we understand the difficulty Texas businesses will face in filing franchise tax returns now that the federal deadline has moved, and so we thought it appropriate to align the state's franchise tax deadline with the IRS deadline."[3]

---

1 Texas Comptroller, *Comptroller's Office Extends Franchise Tax Deadline* (Apr. 2, 2020), *available at* https://comptroller.texas.gov/about/media-center/news/2020/200402-extend-tax-deadline.php.

2 Internal Revenue Service, IR-2020-58 *Tax Day now July 15: Treasury, IRS extend filing deadline and federal tax payments regardless of amount owed* (Mar. 21, 2020), *available at* https://www.irs.gov/newsroom/tax-day-now-july-15-treasury-irs-extend-filing-deadline-and-federal-tax-payments-regardless-of-amount-owed.

3 Texas Comptroller, *Comptroller's Office Extends Franchise Tax Deadline* (Apr. 2, 2020), *available at* https://comptroller.texas.gov/about/media-center/news/2020/200402-extend-tax-deadline.php.

In addition to the automatic extension, the Comptroller announced the process for requesting additional franchise tax extensions. These extensions, like those available every year, require taxpayers to file timely extension requests and include with those requests estimated tax payments. The extensions differ depending upon whether the taxpayer is required to pay franchise tax via electronic funds transfer (EFT).

Entities that paid $10,000 or more in franchise tax (or any other single category of payments or taxes) in the previous state fiscal year are required to pay using EFT.[4]

Extensions for Non-EFT Taxpayers. Taxpayers who are not required to pay via ETF can request one additional extension using the Comptroller's Webfile system or may file Form 05-164, Texas Franchise Tax Extension Request.[5] If the taxpayer properly requests the extension, the report will be due January 15, 2021.

Non-EFT taxpayers must request the extension before the original due date for the report (July 15, 2020). Along with the extension request, the taxpayer must make an "extension payment" equal to the lesser of the following:

1. 90% of the tax that will be due with the report that is ultimately filed; or
2. 100% of the tax reported as due on the prior franchise tax report.[6]

A taxable entity that became subject to the franchise tax for the first time during the 2019 calendar year cannot use the 100% payment option to calculate its extension payment. Also, a separate entity that was included in a combined group report in Report Year 2019 cannot use the 100% payment option.[7] Using the 90% payment option, however, requires the taxpayer to be able to calculate its expected Report Year 2020 franchise tax liability, which the taxpayer is typically unable to do before submitting its federal income tax return.

If the taxable entity fails to meet the "extension payment" requirements once it files its Report Year 2020 report, penalty and interest applies to any part of the 90% of tax not paid by the July 15, 2020 due date and to any part of the 10% not paid by the extended due date.[8] If a taxpayer does not meet the minimum payment threshold, the extension is denied and the taxpayer's report remains due on the July 15, 2020 due date.[9]

Extensions for EFT Taxpayers (Two-Step). Taxpayers required to pay Report Year 2020 franchise tax via EFT must request two extensions. The first extends the due date to August 15, 2020, and the second extends the due date to January 15, 2021.

---

4 Comptroller Rule 3.9(b).

5 Texas Comptroller, Franchise Tax Extensions of Time to File, https://comptroller.texas.gov/taxes/franchise/filing-extensions.php (last visited Jan. 13, 2021). Access to the Comptroller's Webfile system and downloadable forms are available at https://comptroller.texas.gov/taxes/file-pay/.

6 *Id.*

7 *Id.*

8 *Id.*

9 Failing to secure a valid extension causes the statute of limitations to begin running on the original due date. Tex. Tax Code § 111.201 (four-year limitations period begins once tax is due and payable).

If the taxpayer paid between $10,000 and $499,999.99 in franchise tax in Report Year 2019, they may meet the extension payment requirement by using the Comptroller's Webfile system to make their payment.

If the taxpayer paid $500,000 or more in franchise tax in Report Year 2019, they must use the Comptroller's TEXNET system. They may request an extension by making a timely TEXNET payment using tax type payment code 13080 (Franchise Tax Extension). They must complete the payment information by 8:00 PM (CT) on Tuesday, July 14, 2020.[10] Taxpayers do not use the Comptroller's Form 05-164, Texas Franchise Tax Extension Request when using TEXNET and payment code 13080 (Franchise Tax Extension).[11]

Along with the extension request, the taxpayer must make an "extension payment" equal to the lesser of the following:

1. 90% of the tax that will be due with the report that is ultimately filed; or
2. 100% of the tax reported as due on the prior franchise tax report.[12]

Special restrictions apply to the use of these two options for combined groups and separate entities that were included in a combined group in the prior year.[13]

After receiving the first extension to August 15, 2020, the taxable entity may request a second extension to January 15, 2021. The taxpayer must use either Webfile or TEXNET (depending on the amount of tax paid in the prior year) to make a second extension payment. The second extension payment must be the balance of the amount that will ultimately be due minus the first extension payment. This requires the taxpayer to know with certainty its ultimate franchise tax liability. If the taxpayer has already paid 100% of the tax due for Report Year 2020 with its first extension request, it may use Form 05-164, Texas Franchise Tax Extension Request.[14]

Final Report Extensions. A final report and payment of tax are due within 60 days once a taxable entity no longer has Texas franchise tax nexus or is subject to Texas franchise tax.[15] Taxpayers may request extensions for these reports using the Comptroller's Webfile or TEXNET systems, or using the Form 05-164, Texas Franchise Tax Extension request. The appropriate method will depend on whether the taxpayer is required to pay the tax via EFT, and whether an EFT payor must use the Webfile or TEXNET systems. The taxpayer must make an estimated payment of at least 90% of the

---

10 Texas Comptroller, Franchise Tax Extensions of Time to File, https://comptroller.texas.gov/taxes/franchise/filing-extensions.php (last visited Jan. 13, 2021). Access to the Comptroller's Webfile and TEXNET systems and downloadable forms are available at https://comptroller.texas.gov/taxes/file-pay/.

11 *Id.*

12 Comptroller Rule 3.585(f).

13 Comptroller Rule 3.585(f)(3)(B).

14 Texas Comptroller, Franchise Tax Extensions of Time to File, https://comptroller.texas.gov/taxes/franchise/filing-extensions.php (last visited Jan. 13, 2021). Access to the Comptroller's Webfile and TEXNET systems and downloadable forms are available at https://comptroller.texas.gov/taxes/file-pay/.

15 Comptroller Rule 3.584(c)(4).

tax that is ultimately due. If the taxpayer files a timely extension request, the extended due date will be 45 days after the original due date, i.e., 105 days after it no longer has Texas nexus.[16]

Taxable Entities

Motor Carriers. Under Texas law, motor carriers are exempt from occupation taxes measured by gross receipts.[17] In a recent hearing, a motor carrier sought a franchise tax refund, arguing that the franchise tax is an occupation tax measured by gross receipts. The ALJ described the argument that the franchise tax is an occupation tax as "not without merit" because "a franchise tax . . . is very similar to an occupation tax."[18] The ALJ found that the franchise tax was not an occupation tax, for two reasons. First, franchise tax revenue is not appropriated consistent with occupations tax revenue under the Texas Constitution. Also, an occupation tax is imposed for the privilege of carrying on a business, whereas the franchise tax was imposed "in exchange for the state's liability shield."[19]

This issue formed the basis for several refund hearings.[20] As these hearings concluded with Comptroller's decisions denying the refund claims, several transportation companies brought district court lawsuits asserting that the Texas franchise tax is an occupation tax measured by gross receipts from which motor carriers are exempt. Once such suit, *Swift Transportation v. Hegar*, was decided in favor of the Comptroller on December 11, 2020.[21] The taxpayer filed a notice of appeal with the Third Court of Appeals on December 18, 2020.[22] Other cases remain on hold in Travis County District Court pending the outcome of *Swift Transportation*.

---

16 Texas Comptroller, Franchise Tax Extensions of Time to File, https://comptroller.texas.gov/taxes/franchise/filing-extensions.php (last visited Jan. 13, 2021). Access to the Comptroller's Webfile and TEXNET systems and downloadable forms are available at https://comptroller.texas.gov/taxes/file-pay/.

17 Tex. Transp. Code § 20.001.

18 Comptroller Hearings 115,869; 116,055 (June 20, 2019) *quoting In re Nestle USA, Inc.*, 387 S.W.3d 610, 621 (Tex. 2012).

19 *Id.*

20 The Comptroller reached the same result in other hearings involving the same or similar issues. Comptroller Hearing 116,056 (Oct. 8, 2019); Comptroller Hearing 116,615 (Dec. 12, 2019).

21 *See, e.g., Swift Transportation Co. of Arizona v. Hegar*, D-1-GN-20-001080 (126th Dist. Ct., Travis County, filed Feb. 21, 2020).

22 Cause no. 03-20-00600-CV.

COGS

Satellite Radio Service Not Engaged in Sale of Goods. In *Hegar v. Sirius XM Radio, Inc.* the court found that Sirius was not engaged in the sale of goods, and was therefore ineligible to claim the cost of goods sold subtraction.[23] Sirius provides subscription-based satellite radio service, producing most of its radio content exclusively for customers, transmitting content to satellites, and then receiving and unscrambling the satellite signals in its customers' vehicles.

Sirius paid car manufacturers to install satellite-enabled radios in vehicles, hoping to later sell subscriptions to those vehicles' owners. Sirius claimed that it was entitled to amend its cost of goods sold subtraction to include the payments to manufacturers to subsidize the installation of the satellite radios.[24]

To claim the cost of goods sold subtraction, a taxable entity must sell "goods," which are real or tangible personal property.[25] The subtraction is generally unavailable to an entity selling only services. "Tangible personal property" is defined as "personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner."[26] This includes "films, sound recordings, videotapes, live and prerecorded television and radio programs, books, and other similar property embodying words, ideas, concepts, images, or sound."[27] A taxpayer engaged in the sale of goods is entitled to include all direct costs of producing the goods in its cost of goods sold subtraction.[28]

The court rejected Sirius XM's argument that it sold "live and prerecorded . . . radio programs" that were "produced" by its unscrambling of the satellite signals in the vehicles.[29] The court relied on the Texas Supreme Court's finding in *American Multi-Cinema* that "property with a physical or demonstrable—that is, tangible—presence must be transferred."[30] The Attorney General filed a supplemental brief in *Sirius XM*'s case just after the *American Multi-Cinema* Texas Supreme Court Opinion was published, noting that Sirius XM had "analogized satellite radio to the exhibition of films" in Sirius XM' briefing to the Texas Supreme Court.[31] The Court reasoned that, just like AMC's theatergoers, Sirius' customers did not transfer property with a physical or demonstrable form to its customers, but merely provided them temporary access to creative content.[32] Sirius XM has petitioned the Supreme Court for review, and amicus curiae briefs have been submitted by Tax

---

23 *Hegar v. Sirius XM Radio, Inc.*, Cause No. 03-18-00573-CV (Tex. App.—Austin, May 1, 2020, pet. filed). The Third Court of Appeals also rejected an argument by Sirius that it was entitled to apportion its Texas receipts using the location where it produced its content. See **Apportionment** below**.**

24 Sirius also paid a share of revenue to these manufacturers. Slip op. at 6.

25 Tex. Tax Code § 171.1012(a)(1).

26 Tex. Tax Code § 171.1012(a)(3)(A)(i).

27 Tex. Tax Code § 171.1012(a)(3)(A)(ii).

28 Tex. Tax Code § 171.1012(c).

29 Slip op. at 18–19. Tex. Tax Code §

30 *Sirius XM* slip op. at 19 (citing *Hegar v. American Multi-Cinema, Inc.*, No. 17-0464 (Tex. 2020).

31 Appellant's Supplemental Brief at 1, *Sirius XM Radio, Inc.*, Cause No. 03-18-00573-CV (Tex. App.—Austin, May 1, 2020, no pet. h.)

32 Slip op. at 20.

Executives Institute (TEI), Texas Taxpayers and Research Association (TTARA), and Council on State Taxation (COST).

Ready-Mix Concrete. U.S. Concrete manufactured and delivered ready-mixed concrete using mixer-trucks whose constantly rotating drums kept the product in an unhardened state on its way to its customers' job sites. U.S. Concrete argued that its mixer-trucks constituted manufacturing plants on wheels, and that the unhardened concrete becomes a good only when poured from the truck at a job site. Accordingly, U.S. Concrete argued that it was entitled to subtract all of its costs related to its mixer-trucks, mixer-truck drivers, and the dispatchers who oversaw orders for ready-mixed concrete.

The Comptroller disagreed and disallowed 70% of U.S. Concrete's mixer-truck costs, 41% of its mixer-truck driver costs as costs relating to distribution or rehandling and not costs of producing the ready-mixed concrete, and capped the company's dispatcher costs at 4% as indirect costs.

The court found for the Comptroller, rejecting U.S. Concrete's argument that unhardened concrete becomes a "good" for purposes of COGS only upon being poured from the truck at the job site because, even in its unhardened state, it is still personal property that can be seen, weighed, measured, felt, touched and otherwise perceive by the senses, and therefore constitutes a "good" well before it is delivered to job sites. The court also found that evidence in the record supported the Comptroller's distinction between costs that U.S. Concrete incurred related to its trucks manufacturing, and costs related to transportation.

The court further determined that U.S. Concrete's dispatchers were not directly involved in the manufacture of the ready-mixed concrete and therefore it could not subtract the costs related to the mixer-truck dispatchers. The Texas Supreme Court denied review on December 11, 2020, leaving the Third Court of Appeals' decision to stand.[33]

Apportionment

Single-Factor Formula. An entity apportions its taxable margin to Texas by multiplying it by an apportionment fraction. The apportionment fraction is determined using only gross receipts. The numerator is the entity's gross receipts from business done in Texas and the denominator is the entity's entire gross receipts.

Gross Receipts. The statutory definition of gross receipts means all revenues reportable by the entity on its federal tax return without deduction for the cost of the property sold, materials used, labor performed, or other costs incurred, unless otherwise provided.[34]

The Comptroller's Rule clarifies that in most cases, total gross receipts will equal total revenue as calculated under the revised franchise tax, except for three specific circumstances:[35]

---

33 *U.S. Concrete v. Hegar*, 03-17-00315-CV, 2019 WL 1388714, at *3 (Tex. App.—Austin Mar. 28, 2019, pet. filed) (pending before Texas Supreme Court, No. 19-0763).

34 Tex. Tax Code §171.1121(a).

35 34 Tex. Admin. Code § 3.591(b)(4).

- The entity is a health care provider or institution that takes the revenue exclusion for uncompensated care;
- The entity is a law firm that takes the revenue exclusion for pro bono services; or
- The entity is a broker or dealer that accounts for loans and securities as inventory for federal income tax purposes, or "Securities Available for Sale" or "Trading Securities" or the entity is a financial institution that categorizes a loan or security as "Securities Available for Sale or "Trading Securities" under Financial Accounting Standard No. 115.[36]

For the first two circumstances, total gross receipts is not reduced by the revenue exclusion. For the third circumstance, the entity will report the gain on the sale of securities as revenue, but it should report the gross proceeds, from the sale of total gross receipts.[37]

Texas Gross Receipts. Once "gross receipts from everywhere" is established, taxpayers must determine the gross receipts apportioned to Texas. Taxpayers determine Texas gross receipts by applying the general and specific rules that the Legislature, the courts and the Comptroller have fashioned over time.

Comptroller Adopts Sweeping Apportionment Rule Amendments. On January 15, 2021, the Texas Comptroller will adopt broad amendments to his Rule 3.591 governing franchise tax apportionment. In doing so, the agency rewrote numerous detailed rules for sourcing dozens of different types of receipts. Notably, for receipts from services that don't fall under one of the specific rules, the Comptroller's rule codifies the "end-product act" test which first appeared in a 1980 Comptroller Hearing[38] and was recently employed by the Third Court of Appeals in *Hegar v. Sirius XM Radio, Inc.*[39] The Comptroller intends to apply the adopted rule retroactively except for a few provisions which he concedes are changes in policy.

The adopted rule also:

- Codifies recent policy excluding net losses from sales of investments and capital assets (prospectively)
- Distinguishes between financial derivatives sold for hedging and securities treated as inventory, but sources both categories to the location of the payor
- Restricts transportation companies who elect to apportion revenue using mileage from including uncompensated mileage (prospectively)
- Increases Texas' census-based apportionment to 8.7% (prospectively)
- Changes terminology throughout

The Comptroller has formally adopted these changes which were published in the January 15, 2021 issue of the Texas Register. Because some of the changes explicitly take effect in report year 2021, the Comptroller is poised to apply the other provisions retroactively. He signaled this intention by

---

36 Tex. Tax Code §171.106(f-1) (as amended by HB 4611, 81st Reg. Sess. 2009).

37 Tax Policy News, Texas Comptroller (June 2009).

38 Comptroller Hearing 10,028 (1980).

39 No 03-18-00573-CV (Tex. App.—Austin 2020, pet. filed).

asserting in the proposed rule that they "reflect current guidance," while simultaneously admitting that the amendments require that he "supersede prior inconsistent rulings." 45 Tex. Reg. 8104, 8107.

End-Product Act

Texas Tax Code Section 171.103(a)(2) provides that receipts from "each service performed in this state" are sourced to Texas. For many years the Comptroller was relatively consistent in using the cost of performance method to source receipts from services. Under this method, taxpayers apportion their receipts to Texas based on the relative cost of providing the services in Texas as contrasted with the cost of providing services everywhere. The Texas Comptroller has decided to follow a number of states who have amended their statutes to adopt a sourcing method referred to as "market-based" sourcing. Under market-based sourcing, taxpayers apportion receipts to the location of the benefit of the services received by their customers. In other words, sourcing under this methodology is based on the state in which the services are delivered rather than the state in which the services are performed.

The Comptroller justifies his rule amendment by using the 1980 administrative decision referenced above. Under his new change in policy, the Comptroller provides general rules for sourcing receipts from performing services to the location of the "receipts-producing, end-product act." Rule 3.591(e)(26)(A). Under this test, if there is a receipts-producing, end-product act, the location of other acts will not be considered even if they are essential to the performance of the receipts-producing acts. The Comptroller's justification for disregarding essential activities is that to source receipts otherwise would devolve into using factors like property and payroll as proxies because "no activity of a corporation that generates services receipts is any more important than any other activity, since all are essential to the end-product performance of the service that is sold." 45 Tex. Reg. 8107 (quoting Comptroller Decision No. 10,028).

"If there is not a receipts-producing end-product act, the location of all essential acts may be considered." Rule 3.591(e)(26)(A). For example, receipts from sales of admissions to live or pre-recorded events are sourced to the location whether the recipients observe the performance, not where a live performance was rehearsed, or where a pre-recorded performance was recorded, or the place where the admission fee was paid. Rule 3.591(e)(26)(A)(i).

If services are performed both inside and outside Texas for a single charge, the receipts can be apportioned to Texas based on the fair value of the service performed in Texas. To determine fair value, the relative value of each service provided on a standalone basis may be considered. Multi-state services can be apportioned based on hours worked. If costs are used as a proxy for value, taxpayers may only include direct costs, not overhead. The rule provides examples for attorneys (based on hours billed from in-state and out-of-state offices) and landscapers (based on number of customer's locations landscaped in-state and out-of-state, disregarding travel costs).

The Comptroller has issued inconsistent guidance when applying his end-product act rule. This has resulted in taxpayers with similar facts filing franchise tax reports using inconsistent sourcing methods. Since the Comptroller intends to apply his end-product act changes retroactively, we are interested to see how these changes will be applied during audits of taxpayers for prior periods.

Net Gains or Losses from Sales of Capital Assets or Investments

The Comptroller has fundamentally changed the calculation for apportioning gains and losses from the sale of non-inventory assets. Under his prior policy, net losses, in the aggregate, would offset net gains, in the aggregate, subject to certain limits. Under his new policy, net losses arising from individual sales of capital assets or investments are simply ignored. Thus, only the net gains are included in gross receipts. This transaction-level computation applies prospectively beginning with report year 2021. Rule 3.591(e)(2)(A), (C). We anticipate that taxpayers with high volumes of sales of investments and capital assets may face challenges obtaining the information necessary to apply a transaction-level analysis.

Transportation

Under the adopted rule, taxpayers may elect to apportion transportation services receipts using one of two formulas:

(A) *gross receipts* from Texas intrastate transportation / gross receipts from transportation

OR

(B) C*ompensated mileage* from Texas intrastate transportation / total compensated mileage

After proposing to do away with mileage-based apportionment altogether, the Comptroller acquiesced to public comments and retained the mileage option, but modified it. Under the new mileage option, taxpayers may no longer include "uncompensated mileage," which appears designed to exclude trips taken without cargo. Rule 3.591(e)(33). Previously, taxpayers electing to use mileage-based apportionment had a potential further option between including only miles from paid trips (with passengers or cargo) in the numerator and denominator or including all mileage in the apportionment factors (which would include "empty miles" trips without passengers or cargo).

Census-Based Percentage Apportionment

Census-based percentage apportionment to Texas increases from 7.9% to 8.7%. This applies to sales of securities through an exchange to unidentified payors, and advertising where audiences cannot otherwise be determined. Rule 3.591(e)(1), (25).

Sourcing Rules for Various Categories of Receipts

The Comptroller has adopted new rules or modified existing rules for sourcing of receipts from various other types of transactions. Many of the more significant new apportionment provisions are summarized in the following table:

Type of Receipts	Sourcing Rule	Rule Subsection

Advertising	Regardless of the type of media in which an advertisement is transmitted, advertising receipts are sourced to the location of the audience. If the audience locations cannot be reasonably determined, taxpayers may use the fixed 8.7% census-based figure. For report year 2020 and earlier, advertisers may use the physical location of radio or TV station transmitters.	Rule 3.591(e)(1)
Computer Hardware and Software	Hardware and software receipts are sourced as the sale of tangible personal property if the hardware is sold with software installed on it. Digital property transferred by "fixed physical media" (e.g., compact disc) is sourced as the sale of tangible personal property. Digital property not transferred by fixed physical media is sourced as the sale of an intangible to the location of payor. Digital property as a service is sourced under the end-product act rule.	Rule 3.591(e)(3)
Financial Derivatives	Gross receipts from the settlement of financial derivative contracts (hedges, options, swaps, futures, forward contracts, etc.) are sourced to the location of payor.	Rule 3.591(e)(10)
Internet Hosting (Cloud Computing)	Internet hosting receipts are generally sourced to the customer location. New guidance also distinguishes between purchasing access to a computer service and purchasing or leasing hardware or digital property.	Rule. 3.591(e)(13)
Loan Servicing	Gross receipts from loan servicing are sourced to the location of real property secured by the loan. If the loan is not secured by real property, receipts are sourced based on the end-product act.	Rule 3.591(e)(16)
Loans and Securities Held as Inventory	Loans and securities held as inventory are sourced to the location of payor.	Rule 3.591(e)(17)
Single-Member LLCs	Single member LLCs sold by the sole member are sourced to the location of payor.	Rule 3.591(e)(27)

Vocabulary Changes

Along with the substantive changes to apportioning receipts, the proposed rule adopts a new set of apportionment vocabulary. Many of these changes appear aimed at improving clarity and readability:

Old Term	New Term
Intangibles	Intangible Assets
Computer Program	Digital Property
Receipts	Gross Receipts
Revenue	Gross Receipts
Gross Receipts Everywhere	Gross Receipts from an Entity's Entire Business
Apportioned	Sourced
Legal Domicile of Payor	Location of Payor
Commercial Domicile	Principal Place of Business

Commodity Hedging Receipts. In a recent hearing, the Comptroller held that a packaged food company must exclude its net gains from commodity hedging transactions from the denominator of its Texas apportionment factor. The taxpayer purchased futures contracts in order to protect against price increases in the raw materials it used to manufacture its products. These were "notional contracts" in which neither party actually owned the commodity, and the taxpayer settled the contracts for net gains. For federal tax purposes, the taxpayer treated the proceeds as an adjustment to cost of goods sold. For Texas franchise tax, the taxpayer included the proceeds in its apportionment factor denominator, but excluded them from the numerator, because the commodities exchanges were located outside Texas.

Under Tex. Tax Code § 171.106(f), when calculating apportionment of margin to Texas, "if a loan or security is treated as inventory of the seller for federal income tax purposes, the gross proceeds of the sale of that loan or security are considered gross receipts." A comptroller auditor found that the taxpayer did not treat the commodity hedges as inventory because the taxpayer reported the proceeds of settling the commodities hedges on Line 2 (cost of goods sold) instead of Line 1 (income/loss). The Comptroller has also found that reporting gains and losses on Form 1120, Line 8, as capital gains or losses shows that the securities are held for the taxpayer's own investment, and therefore are not treated as inventory.[40]

A similar issue is pending before the Travis County District Court in *Equistar Chemicals, LP v. Hegar*.[41] Equistar entered into commodities futures contracts to hedge against fluctuations in oil prices. Equistar filed refund claims, amending its apportionment calculation by including the proceeds from these hedging transactions in its calculation of its apportionment factor. Equistar followed a Comptroller rule that requires apportioning a set rate of 7.9% of securities sold through an exchange for which a buyer cannot be identified.[42]

Sourcing of Services Under the "End Product Act" Test. Texas law requires taxpayers to source receipts from the performance of services to Texas if the services are "performed in this state."[43] Yet, the statute provides no guidance for determining where the vast majority of services are performed. The Comptroller has taken the position in his recently amended apportionment rule that receipts from the performance of services should be sourced to the location where the "end product act" is

---

40 Comptroller Hearing Nos. 114,432; 114,433; 114,434; 114,435 (Aug. 15, 2019).

41 D-1-GN-18-004006 (126th Dist. Ct., Travis County, filed Aug. 2, 2018).

42 34 Tex. Admin. Code 3.591(e)(25).

43 Tex. Tax Code § 171.103(a)(2).

performed. This test attributes the receipts to the location of the purchasers (the market) rather than the seller. The Comptroller alleges that he has argued that certain service receipts should be apportioned based on the "end product act" for decades. In a 1980 hearing decision, the Comptroller found that a television broadcasting company's receipts from selling advertising should be based on the location of its broadcast towers.[44] The Comptroller has repeatedly cited this hearing decision for his policy that the location of the final act to deliver the service is the appropriate location to source franchise tax receipts.

The Comptroller has asserted this position with renewed fervor in the last decade, as more and more services are performed remotely. In 2013 the Comptroller found that receipts for satellite TV service should be sourced to the subscriber's address because the signal is descrambled there.[45] In a 2018 Private Letter Ruling the Comptroller found that software that allows customers to reserve airport parking should be sourced to the location of the parking spaces.[46]

Satellite Radio Subscription Service Receipts. In *Hegar v. Sirius XM Radio, Inc.*, the court rejected the taxpayer's apportionment methodology based upon the location where the satellite radio service produced its subscription content.[47] The taxpayer produced its subscription content primarily from studios located outside Texas, transmitting its programs to satellites from facilities outside Texas.

The Comptroller audited Sirius, asserting that its subscription receipts should be apportioned to Texas based on the locations where the satellite transmissions were received by subscribers. The taxpayer's expert witnesses provided testimony that Sirius's apportionment methodology conformed to the "end product act test," focusing on the location where the receipt-producing activities occurred. Based on this test, the trial court found that the creation and broadcasting of original content from locations outside Texas supported sourcing the taxpayer's receipts outside Texas.

The Comptroller appealed this case to the Third Court of Appeals.[48] On May 1, 2020, the Third Court of Appeals reversed the trial court, finding that Sirius XM's satellite radio subscription receipts from subscribers in Texas must be apportioned to Texas regardless of the location from which the content was created or broadcast.[49]

Receipts from services are sourced to the Texas if a service "is performed" in Texas, so the parties took different positions what service Sirius XM actually sold. The Comptroller argued that Sirius provides the "service of unscrambling the radio signal" within each subscriber's vehicle, which occurs "at the radio receiver."[50] The Third Court observed Texas case law precedent, which found that a

---

44 Comptroller Hearing 10,028 (Nov. 12, 1980).

45 Comptroller Hearing 104,224 (May 17, 2013).

46 Comptroller Priv. Ltr. Rul. 20171115102316 (Aug. 13, 2018).

47 *Hegar v. Sirius XM Radio, Inc.*, Cause No. 03-18-00573-CV (Tex. App.—Austin, May 1, 2020, pet. filed). The court also rejected an argument by Sirius that it qualified for the cost-of-goods-sold subtraction based on the determination that it sold services rather than goods. See **Cost of Goods Sold**, above.

48 *Hegar v. Sirius XM Radio, Inc.*, Cause No. 03-18-00573-CV (Tex. App.—Austin, May 1, 2020, no pet. h.).

49 Tex. Tax Code § 171.103(a)(2).

50 Slip op. at 5.

service is performed "where the act is done" to perform the service.[51] The Third Court accepted the Comptroller's position that the focus is on Sirius XM's "receipt-producing, end-product act."[52] The Third Court deferred to the Comptroller's interpretation of the franchise tax statute and applied the "end-product act" analysis to source the receipt based upon the locations where the satellite radio signals were receive, unscrambled, and played through the speakers in customers' vehicles.[53]

Sirius XM has petitioned the Supreme Court for review, and amicus curiae briefs have been submitted by Tax Executives Institute (TEI), Texas Taxpayers and Research Association (TTARA), and Council on State Taxation (COST).

---

51 Slip op. at 9 (quoting *Humble Oil & Refining Co. v. Calvert*, 414 S.W.2d 172, 180 (Tex. 1967) (embedded quotation and citation omitted).

52 Slip op. at 10.

53 Slip op. at 12–14.

II. Sales Tax

Local Tax Rule Revised

The Texas Comptroller has changed his local tax rule to undermine economic development agreements.[54] Local governments, like cities and counties, collect local taxes to finance their governmental operations. Generally, local governments receive local sales taxes based upon orders that local businesses receive within their boundaries. Local governments may also receive local use taxes when goods are delivered to customers within their boundaries. A seller collects local use taxes only when the local sales tax where the item is sold is less than the maximum rate (2%) and the local use tax is not of the same type (such as a city tax or a county tax) as the local sales tax that applied. This may occur, for example, when a seller receives an order outside city limits and sells the product for delivery to a customer residing within city limits.

Generally, local governments want businesses to relocate within their boundaries. In doing so, the relocated businesses provide jobs, goods, services and generate sales and property taxes for the local government's operations.

To induce a business to relocate to a particular city, the city may offer the business incentives, often in the form of shared local sales tax revenues. These offers are authorized under Chapter 380 of the Texas Local Government Code and are commonly known as "Chapter 380" agreements.

As an example, Apple decides to leave California and relocate its headquarters to Texas. To induce Apple to choose Austin, the City of Austin offers Apple a Chapter 380 agreement under which the City will give Apple one-half of the sales tax revenue Apple collects for the City for a five-year period.

Prior to the rule's amendment, whenever a customer places an order on the internet for a new iPhone, Apple would treat the order as received in Austin, and collect sales tax that it would split, for a five-year period, with the City of Austin under the Chapter 380 agreement. This result would follow regardless of where in Texas the customer lives.

Comptroller Hegar says that these types of arrangements are unfair to the local tax jurisdictions where the customers live, so he amended his rule to say the local tax revenue goes to the customer's location, where the item is shipped. Hegar penned an op-ed in the Dallas Morning News in an effort to justify his agency taking the initiative to change Texas' local sales tax rule without a change in the law. Hegar claims that taxpayers and cities use a Chapter 380 "loophole" to create sham facilities to "manipulate local sales taxes to their own benefit at the expense of other cities."[55]

When a Texas customer makes a purchase from a company's website, or by using its mobile app, Comptroller Hegar says the local tax should go to the location where that customer receives the product, since he or she lives there and receives the local governmental services there, which the local

---

54 Comptroller Rule 3.334.

55 Glenn Hegar, *How Some Texas Cities and Retailers Are Using a Tax Loophole to Snatch Sales Tax Revenue from Other Communities*, DALLAS MORNING NEWS, Feb. 4, 2020, *available at* https://www.dallasnews.com/opinion/commentary/2020/02/04/how-some-texas-cities-and-retailers-are-using-a-tax-loophole-to-snatch-sales-tax-revenue-from-other-communities/.

sales tax revenues should help fund. Instead, taxes have been split between the local government where the seller has its business and the seller itself.

Although the amended rule went into effect May 30, 2020, Comptroller Hegar has provided for a transition period through September 2021 before the new sourcing provisions go into effect. He did this to allow the e-retailers adequate time to adjust their systems to collect local tax at the rate in effect at their customer's location and to give interested parties a chance to get the Texas Legislature to craft a different solution during the regular session that began in January 2021.[56]

Data Processing Services

Online Management Reports Taxable. The sales of management reports to customers who use them to manage product inventory levels and achieve substantial reductions in their administrative costs constitute taxable data processing. Instill Corporation provides automated management solutions for the food service industry. Instill's customers and their customer's vendors provide raw data to Instill who compiles it into reports that its customers then use when purchasing inventory, and monitoring inventory levels. The reports enable Instill's customers to achieve substantial administrative cost reductions. Instill treated the revenues it derived from the sale of its solutions as non-taxable proprietary information. The Comptroller audited Instill Corporation and disagreed, assessing over $1 million in sales taxes on Instill Corporation's revenues.

The appeals court concluded that Instill's solutions constituted taxable data processing because they arose from the processing and storage of data on computers. The Texas Supreme Court denied review on August 28, 2020, letting the appeals court's decision stand.

Internet Access Services

Separately Stated Internet Access Charges No Longer Taxable. Effective July 1, 2020, internet access services are no longer taxable in Texas.[57] The federal Internet Tax Freedom Act, first passed in 1998 and last renewed in 2016, set an expiration date of June 30, 2020 for Texas and six other states whose taxes were grandfathered in that legislation. Previously, only the first $25 of a fee paid to access the internet was exempt. Comptroller Hegar's Biennial Revenue Estimate calculates a $500 million loss in tax revenue from the expiration of the tax on internet access.

Insurance Services

Medical Billing Services. The Comptroller's Tax Policy Division issued a memorandum notifying the Audit Division that the Comptroller's new policy will treat medical billing services as taxable insurance services. These will include services performed prior to submitting a claim to an insurance company, to provide additional information, or to adjust a submitted billing. "Insurance services" are included in the exclusive lists of services subject to Texas sales tax.[58] The Comptroller's Rule 3.355 defines these services broadly to include "any activities to supervise, handle, investigate, pay,

---

56 45 Tex. Reg. 3505 (". . . giving interested parties an opportunity to seek a legislative change.").

57 Tax Policy News (May 2020).

58 Tex. Tax Code § 151.0101(a)(9).

settle, or adjust claims or losses" and makes these services taxable regardless of whether the purchaser of the service is the insurance company, the policy holder, or others.[59] Medical billing services are not defined by the statute or the Comptroller's rule. Medical billing services involve assigning codes for the preparation of claims, verifying insurance eligibility, preparing claim forms for filing, filing claims, resubmitting and adjusting claims, reviewing and appealing denied claims, settling claims, and posting payment for claims.[60]

On March 19, 2020, the Comptroller announced that he would delay the implementation of his policy change "until after the 2021 legislative session, allowing industry time to seek a legislative change." He clarified that, in the meantime, "Medical billing services that occur before a claim is submitted do not fall under 'insurance claims adjustment or claims processing' and are not taxable as insurance services."[61]

Occasional Sale Exemption

Court Imposes Fraud Penalty on Aircraft Claim for Occasional Sale Exemption. The Third Court of Appeals recently upheld a trial court decision finding that the 50% fraud penalty applied to a taxpayer who had purchased an aircraft through a broker who claimed the occasional sale exemption. In *HB Aviation, LLC v. Hegar*, HB Aviation, LLC purchased a Cessna Citation Excel aircraft in 2009 from James Creech. James Creech habitually bought and sold aircraft and brokered aircraft transactions through his solely-owned corporation Jim Creech Aircraft Services.[62]

James Creech entered into a "back-to-back" transaction, in which he ostensibly took title to the aircraft from the seller and immediately transferred it to the buyer. He made a roughly 1–1.5% profit on brokering the transactions, but the sale proceeds were never in his possession but passed from the buyer to an escrow agent to the seller. Mr. Creech, however, executed a "Statement of Occasional Sale" to support the exemption, and executed an "Aircraft Purchase & Sales Agreement."

At his deposition James Creech testified that "on paper I've got title to the airplane, but I—I never really owned it" and confirmed that he had no understanding of Texas' occasional sale exemption. The Third Court found that the occasional sale exemption could not apply because there had never been a "sale" of the aircraft to James Creech. As a result, the Court found that statements in the Aircraft Purchase & Sales Agreement and the Statement of Occasional Sale were misrepresentations to the extent they characterized Mr. Creech as receiving title to the aircraft. Since HB Aviation submitted the Aircraft Purchase & Sales Agreement and the Statement of Occasional Sale to the auditor, and these documents contained these misrepresentations, the Third Court upheld the 50% fraud penalty.[63] HB Aviation's deadline to file a motion for rehearing—thereby asking the three-justice panel to reconsider its decision—has been extended to January 15, 2021.

---

59 Comptroller Rule 3.355(a)(8), (b).

60 Comptroller Letter No. 201911003L (Nov. 22, 2019).

61 Comptroller Letter No. 202003007L (Mar. 19, 2020).

62 *HB Aviation, LLC v. Hegar*, No. 03-19-00414-CV (Tex. App.—Austin Nov. 11, 2020, no pet. h.).

63 *HB Aviation, LLC v. Hegar*, No. 03-19-00414-CV (Tex. App.—Austin Nov. 11, 2020, no pet. h.).

Health Care

Support Services. The Texas Comptroller issued a private letter ruling on a variety of health care support services, including "release of information services," "clinical data acquisition and insight services," and "healthcare information management services" provided to medical service providers and others.[64]

The taxpayer's "release of information services" involves operating the medical records departments of medical service providers such as hospitals and doctor's offices. Instead of charging for this service, the taxpayer uses its position as recordkeeper to provide a service of medical records retrieval for a fee, to those who request copies of records. The release of information service also involves offering medical service providers data storage, photocopying, scanning, record retrieval, and the provision of information. The Comptroller found that charges for retrieving and providing medical records, and providing photocopies of medical records, were not taxable. However, charges to medical providers for scanning, data storage, and electronic record retrieval were taxable as data processing services. Sales of photocopies of medical records are taxable as the sale of tangible personal property unless released under the authority of the patient.

The taxpayer's "clinical data acquisition and insights" provides records retrieval services to health insurers for records managed by the taxpayer and in databases the taxpayer does not operate. The taxpayer sometimes processes the retrieved records such as by using specialized coding and data extraction. The Comptroller found these services, when performed for insurance companies, were taxable insurance services.

The taxpayer's "healthcare information management" service involves coding services, scanning and storage services, and data abstraction (mining) services. The initial coding services in relation to the initial submission of an insurance claim are not taxable. Coding audits and reviewing codes related to insurance claims are taxable insurance claims. The taxpayer's software-as-a-service applications provided to perform coding services are taxable as data processing services, as are the data abstraction services.[65]

Energy

Flowback Services Charges Taxable as Rentals. The Comptroller's Tax Policy Division changed its policy finding that "flowback services" are generally not services at all, but are instead treated as the rental of flowback equipment.

After an oil & gas well is hydraulically fractured, a mixture of oil, gas, frac fluid, and saltwater from the formation—known collectively as "flowback"—returns to the surface where it must be filtered and managed to keep the well open and flowing and ensure that the well pressure can normalize after the intense pressure present during fracking. Typically, a service provider offers "flowback services" by providing the following types of equipment along with supervisors who temporarily manage it:

- A choke manifold;

64 Priv. Ltr. Rul. 20190219095143 (Aug. 14, 2020).

65 Priv. Ltr. Rul. 20190219095143 (Aug. 14, 2020).

- A sand separator with gauges to measure oil, water, and gas rates, diagnose problems, evaluate production performance, and manage the reservoir;
- Flowmeters for gas and liquids
- Tanks to hold recovered fluids
- Transfer pumps and piping to attach these components
- A flare boom to burn off flare gas
- Safety systems including emergency shutdowns; and
- A logging cabin to run the data acquisition system.

The Comptroller stated that, typically, the flowback service provider will provide a supervisor for this equipment, but the supervisor may only remain at the wellsite for a couple of weeks, while the flowback equipment typically remains for up to four months. The Comptroller determined that standalone flowback services are to be treated as the rental of tangible personal property, basing that characterization on the following factors:

- The customer has operational control of the equipment by determining where it is placed and the rate at which it operates;
- The equipment works automatically, needing only minor adjustments
- The customer may operate the equipment after the flowback personnel are no longer on site
- The flowback personnel do not "actively guide, drive, pilot, or steer the equipment."

Because "flowback services" are treated as the rental of tangible personal property, the "service provider" may purchase that property for resale. If, however, the flowback services are performed by the same service provider who does the frac job, then charges for those services are taxed under the Well Servicing Tax. As a result, in that instance the sale-for-resale exemption would not apply to the service provider's purchase. The Comptroller's memorandum lists four policy documents spanning over a decade as superseded by the new policy; however, the Comptroller finds that the new policy is a "clarification" and he therefore intends to apply it retroactively.[66]

66 Comptroller Memo 202009002L (Sept. 21, 2020).

I. Legislation

Texas Legislature' 87th Regular Session Convenes

The Texas Legislature meets for its regular session once every two years on odd-numbered years. The 87th Regular Session began on January 12, 2021.

Texas Legislature 87th Regular Session Pre-Filed Bills

Legislators began pre-filing bills on November 9, 2020. Below are brief descriptions of relevant tax bills and other bills that might affect your clients or your practice. Each bill number below is a hyperlink that should take you to the Texas Legislature Online webpage for the bill. You can click on these links before, during, and after the legislative session to see the status of each bill. You can review the bill text by clicking one of the three icons on the "Text" tab under the word "Bill."

Sales Tax Bills

HB 288 – This bill would expand the sales tax base to make up for revenue lost by eliminating most school district property taxes. Legal, accounting, audit, engineering, real estate brokering and real estate agency services would all become taxable services. Tickets to high school and college sports events would be taxed as amusement services. The additional revenue would be deposited to a new "school district reimbursement trust fund" outside the state treasury to be used by the Comptroller to reimburse school districts.

HB 89 – This bill would exempt disinfectant cleaning supplies, face masks, and disposable gloves from sales tax for a limited period of time.

HB 174 / HB 406 – These bills would exempt college textbooks from sales tax for a week around the beginning of each fall and spring semester.

HB 211 / SB 216 – These bills creates a new sales tax that applies to e-cigarette vapor products.

HB 321 / HB 388 / HB 490 / SB 148 – These bills would create a sales tax exemption for feminine hygiene products.

HB 322 / HB 387 – These bills would create a sales tax exemption for child and adult diapers.

SB 60 / HB 524 – These bills would exempt firearm safety supplies from sales tax.

SB 140 / HB 447 – These bills would legalize cannabis and subject it to sales tax at a rate of 10%. We have included these bills as examples, but there are many other cannabis legalization bills, some of which may also have state tax implications.

HB 592 – This bill would create a sales tax exemption for fees charged for animals adopted from animal rescue groups. Animal adoption fees imposed by nonprofit shelters are already exempt.

SB 153 – This bill would exclude certain payment processing services from the definition of "data processing service." This applies broadly to any "processing of payment made by credit card or debit card."

SB 200 – This bill would remove "internet access services" from the list of taxable services. Texas is already prohibited from collecting tax on internet access services effective July 1, 2020 due to the federal Internet Tax Freedom Act.

HB 940 – This bill would make beer sold on the Fourth of July exempt from sales tax.

SB 296 – This bill would require that resale and exemption certificate be provided to an auditor at or before the exit conference. Current law allows certificate to be submitted up until 60 days after written notice, which occurs after the audit concludes and the taxpayer petitions for redetermination.

Franchise Tax Bills

HB 209 – This bill provides a franchise tax credit for establishing a grocery store or healthy corner store in a food desert.

HB 361 – This bill creates a franchise tax credit for four weeks of paid family care leave. The credit is the lesser of twice the costs attributable to the leave or the total tax due after applying all other credits.

HB 864 – This bill creates a franchise tax credit pilot program for taxable entities that contribute to an employee dependent care flex spending account. The credit is limited to entities with 500 or fewer employees and applies only to accounts for employees earning $65,000 per year or less. The credit is equal to the lesser of 50% of the contributions or $2,500 per employee but is capped at the entities' franchise tax liability.

Other Important Pre-Filed Legislation

HB 70 / HJR 6 – These bills would require legislative approval of proposed agency rules with an anticipated economic impact greater than $20 million, as determined by the agency. HJR 6 proposed a constitutional amendment to authorize this.

HB 207 – This bill would increase the gasoline and diesel fuels tax rate from 20 to 22 cents/gallon and provide for future rate increases to be tied to inflation.

HB 339 – This bill makes a statewide "reapportionment" of the court of appeals districts. The introduced version doesn't appear to affect the Third Court of Appeals, which handles all appeals of Texas franchise tax and Texas sales tax protest and refund cases unless those cases are reassigned by the Texas Supreme Court. The Texas Supreme Court routinely transfers cases—including tax cases—to other courts of appeals to level the courts' workloads through "docket equalization transfers."

HB 645 / HRJ 36 – These bills require "the use of honest state taxation terminology" in legislation, rules, materials, publication, and electronic media. They define a "regulatory tax" broadly, then prohibits the government from referring to any tax as a "fee," "levy," "surcharge," "assessment," "fine," or "penalty."

SB 133 – This bill would facilitate adjusting dollar amounts in Texas tax statutes for inflation by creating biennial reports from the Comptroller to the Legislature detailing how tax collections would change by adjusting statutory figures for inflation.

HB 433 – This bill would create a new tax on the generation of electricity—except by natural gas—imposed on the electric generator at a rate of 1 cent per kilowatt hour.

HB 477 – This bill would legalize gambling in some coastal areas and impose a new "Casino Gaming Tax" equal to 18% of a casino's gross gaming revenue. Revenue would be partially earmarked to cover costs of catastrophic flooding in those coastal areas.

HB 647 / HJR 37 – These bills would allow local governments to legalize or prohibit the operation of "eight-liners" and impose a $350 annual fee on each machine. The tax revenue would be split with 30% allocated to the state general revenue fund and 70% allocated to the municipality (or the county for machines outside city limits).

SB 159 – This bill would extend the prohibition against using the Texas Open Records Act to obtain lists of taxpayers currently under audit for solicitation to 30 days after the Comptroller makes the information available to the requestor. Using this information for solicitation is currently only prohibited for 6 days after the Comptroller makes the information available.

Links:

Separate lists of all bills filed to date in each chamber are available here:

- House bills: https://capitol.texas.gov/Reports/Report.aspx?LegSess=87R&ID=housefiled
- Senate bills: https://capitol.texas.gov/Reports/Report.aspx?LegSess=87R&ID=senatefiled

II. Jurisdiction

Texas Supreme Court Rejects Pay-to-Play Requirement

The Texas Supreme Court held that a taxpayer may gain access to the Texas courts without first paying the tax assessment in full if it satisfies the appropriate jurisdictional requirements.[67] EBS Solutions was audited for franchise tax and received an assessment of tax, penalties, and interest for four year of almost $300,000.[68]

EBS was unable to pay the full assessment. Generally, a taxpayer must pay the entire amount of tax, penalties, and interest assessed "under protest" in order to gain access to the courts.[69] For taxpayers with large assessments and limited funds, this has effectively barred access to a neutral judge, forcing the taxpayers to challenge their assessments in the administrative forum, where the Comptroller alone decides whether or not his assessment is correct.

The Legislature provided an exception to the prepayment to requirement based on inability to pay:

1. [a]fter filing an oath of inability to pay the tax, penalties, and interest due, a party may be excused from the requirement of prepayment of tax as a prerequisite to appeal if the court, after notice and hearing, finds that such prepayment would constitute an unreasonable restraint on the party's right of access to the courts. The court may grant such relief as may be reasonably required by the circumstances.[70]

EBS payed $150,000 and filed an oath of inability to pay for the remainder. EBS also filed a statement of grounds with the Texas Attorney General for seeking an injunction prohibiting the Comptroller from collecting the remainder of the assessment.[71] The Comptroller argued that the statute has been declared unconstitutional and, therefore, partial prepayment of taxes owed is insufficient to give a court jurisdiction over the taxpayer's suit.[72] The Texas Supreme Court found that the inability-to-pay exception quoted above made the statute constitutional, because it protects a party's right of open access to the courts even if that party cannot prepay the entire assessment.[73] The Court rejected the Comptroller's pleas that allowing EBS' suit to proceed would open the floodgates to taxpayers abusing the inability-to-pay exception.[74]

Recent Wins and Losses for Taxpayers on Jurisdiction

Declaratory Relief Claims Allowed in Tax Protest Suit. The jurisdictional tide may be turning in Texas. Prior to May 9, 2019, Texas taxpayers were generally barred from pursuing claims for "declaratory relief" in tax protest and tax refund suits. As a result, taxpayers were unable to seek

---

67 *EBS Solutions, Inc. v. Hegar*, No. 18-0503 (Tex. May 8, 2020).

68 Slip op. at 2.

69 Tex. Tax Code § 112.052(a).

70 Tex. Tax Code § 112.108.

71 Slip op. at 2–3.

72 *EBS Solutions, Inc. v. Hegar,* No. 18-0503, slip op. at 1 (Tex. May 8, 2020).

73 Slip op. at 25.

74 Slip op. at 28–29.

attorney's fees otherwise available for declaratory claims. In general, a claim for "declaratory relief" asks the court to determine the litigating parties' rights under a statute or rule. In a tax suit, a claim for "declaratory relief" would seek the court's ruling construing tax statutes and rules for the future.

Historically, courts have barred taxpayers from raising claims for "declaratory relief," reasoning that a court's judgment awarding recovery of the overpaid taxes implicitly provides the future guidance that taxpayers seek. As a result, the courts considered the claims for "declaratory relief" to be unnecessary and redundant.

However, times have changed. The Texas Comptroller no longer treats a court decision or judgment ordering the refund of taxes as providing any guidance on how the tax laws apply in the future. In *CSG Forte Payments, Inc. v. Hegar*, the Comptroller refuses to apply the decision in *Hegar v. CheckFree Services Corporation* as judicial precedent to Forte, a similarly-situated provider of electronic payment services.[75] In *Pointsmith Point-of-Purchase Management Services, LP v. Hegar*, the Comptroller went even further.[76] There, the Comptroller refused to apply the state court judgment rendered in favor of Pointsmith for one audit period to resolve the same tax issue arising in Pointsmith's subsequent audit period. So, Pointsmith was forced to file yet another lawsuit on the exact same issue. According to the Comptroller, a Texas judgment does not provide prospective guidance to any taxpayer, including the taxpayer to whom the judgment is issued.

In light of this change in the Comptroller's position, on May 10, 2019, a state district court issued its order in *CSG Forte Payments, Inc.* denying the Comptroller's challenge to Forte's right to pursue claims for declaratory relief. Specifically, the court's order allows Forte to proceed with its claims for declaratory relief under the Administrative Procedure Act, Uniform Declaratory Judgments Act (UDJA), and the *ultra vires* doctrine. The Third Court of Appeals reversed the district court and dismissed Forte's UDJA and *ultra vires* claims on December 9, 2020.[77]

Attorney's Fees Are a Two-Way Street. The Court of Appeals recently upheld a trial court's award of attorney fees to a state agency in a UDJA case. Two licensed deer breeders brought suit against the Texas Parks and Wildlife Department seeking declarations that certain department rules involving captive deer were unconstitutional. The breeder also sued department officials, alleging that they acted *ultra vires* (i.e., without authority) by adopting the rules. Texas law provides that, "[i]n any proceeding under [the UDJA], the court may award costs and reasonable and necessary attorneys fees as are equitable and just."[78] Although the Appeals Court agreed that the trial court lacked jurisdiction over the breeders' UDJA claims, it found the trial court still had jurisdiction to award attorney's fees.[79]

---

75 *See* No. D-1-GN-18-006671 (345th Dist. Ct., Travis County, Tex. filed Nov. 2, 2018).

76 *See* No. D-1-GN-18-007023 (345th Dist. Ct., Travis County, Tex. filed Nov. 26, 2018).

77 03-19-00325-CV (Tex. App.—Austin 2020, no pet. h.).

78 Tex. Civ. Prac. & Rem. Code § 37.009

79 *Bailey v. Smith*, Cause No. 03-17-00703-CV (Tex. App.—Austin 2019, pet. denied) (pending motion for rehearing at the Texas Supreme Court, No. 19-0695).

This case presents a cautionary tale for taxpayers seeking to pursue UDJA claims against the Comptroller. Although the UDJA may be appropriate for particularly meritorious claims involving bad faith by the Comptroller, raising the claim likely turns the case into a "proceeding under the

Judicial Review of Penalties & Interest Waiver. A Texas court ruled that the courts have jurisdiction to review the Comptroller's discretionary authority to waive all or part of the tax, penalty, or interest found due.[80]

J.D. Fields & Company is a pipe and piling distributer headquartered in Houston. The Comptroller initially audited J.D. Fields for sales tax compliance for reporting periods between April 2005 and May 2008. At the conclusion of that audit, the Comptroller found that J.D. Fields was incorrectly collecting local sales tax based on the location where pipes were delivered rather than where the sale took place.[81] At the conclusion of that audit, according to J.D. Fields, the auditor told the taxpayer that it was not necessary to begin collecting tax based on the location of the sale. When J.D. Fields' CFO asked the auditor if the company could wait until January 1, 2009 to begin collecting tax correctly, the auditor allegedly said "I think that will be fine."[82]

In 2012, the Comptroller audited J.D. Fields again, and assessed tax for June 2008 through December 2008 (among other periods) based on J.D. Fields' improper local tax collection. J.D. Fields requested relief from the assessment on the ground that it relied on the auditor's statement to the CFO that J.D. Field could correct the practice beginning January 1, 2009. The Comptroller's rules provide that "The [C]omptroller will give relief to a taxpayer who follows erroneous advice given to a taxpayer by an agency employee."[83] The Comptroller argued that his discretion in providing relief was absolute, based entirely on equitable discretionary considerations, and that a taxpayer could not even raise the issue in a suit challenging a tax assessment.[84] The court rejected this argument, stating:

> That the Comptroller's rules require it to take certain equitable considerations into account when deciding claims for relief does not affect the Comptroller's obligation to follow those rules when deciding claims.[85]

The court followed with "[w]e do not agree that the Comptroller's discretion is absolute."[86] The court noted that the statute allowing the Comptroller to waive penalties and interest provided "a specific and objective standard to govern the Comptroller's exercise of judgment" because the statute provides for waiver if a taxpayer "exercised reasonable diligence to comply with" the tax laws.[87]

---

80 *Hegar v. J.D. Fields & Company, Inc.*, No. 03-19-00351-CV (Tex. App.–Austin Apr. 15, 2020, pet. filed).

81 Slip op. at 1–2.

82 Slip op. at 2.

83 Comptroller Rule 3.10(c). See also Comptroller Rule 3.5(b)(3)(K) (identifying "reliance on advice provided by the [C]omptroller's office" as a factor for penalty and interest waiver).

84 *Hegar v. J.D. Fields & Company, Inc.*, No. 03-19-00351-CV, slip op. at 2–3 (Tex. App.–Austin Apr. 15, 2020, pet. filed).

85 Slip op. at 5.

86 Slip op. at 6.

87 Tex. Tax Code § 111.103(a).

The Comptroller has appealed the decision to the Texas Supreme Court.

Franchise Tax Estimated Payments Made by ETF Must Be Made Under Protest. The Court of Appeals recently found that a taxpayer lacked jurisdiction to bring its Texas franchise tax protest suit when the taxpayer, an Electronic Funds Transfer (EFT) filer, did not make a proper protest payment along with its original extension request.

Franchise tax reports are generally due May 16 of each year. Taxpayers are granted extensions if they timely request the extension and make remit an estimate of their tax liability with the extension request. Under Texas law, certain taxpayers are permitted to wait and file their protest letters on the extended deadline. Other taxpayers must file a protest letter with the original payment and extension request, or they are treated as not having made the payment under protest. Reading convoluted Texas statutes, the court found that all taxpayers required to make payments via EFT must file their protest letters with their original payments or lose the critical procedural advantages that taxpayers enjoy when contesting tax issues after having properly made protest payments.[88]

The consequence of having a payment not treated as a protest payment can be dire. Before they can go to court, the taxpayer is forced to pursue their tax controversy through a lengthy administrative refund process during which the Comptroller almost invariably finds in his own favor. Further, the Comptroller has unilateral authority to delay the process indefinitely. Only after the Comptroller finally allows the taxpayer to exit the administrative process can the taxpayer bring its claim in court.

Quoting Refund Statute Insufficient to Maintain Jurisdiction. A two-justice majority of the El Paso Court of Appeals sided with the Comptroller and dismissed El Paso Electric Company's sales tax refund suit for failing to adequately raise its legal arguments at the administrative level. El Paso Electric Company is a fully integrated public utility in the business of manufacturing, generating, transmitting and distributing electricity in west Texas and southern New Mexico.[89] El Paso Electric filed an administrative sales tax refund claim for a variety of different types of equipment under a variety of sales tax exemptions. Of the $5.1 million total refund El Paso sought, the Comptroller agreed to refund over $2.5 million.

The Comptroller would not agree to refund sales tax El Paso allegedly paid in error on the purchase of meters and disconnect collars that El Paso believed were exempt because they were "telemetry units related to step-down transformers," a specific type of exempt manufacturing equipment.[90] After the Comptroller denied El Paso's administrative refund claim, El Paso filed a district court lawsuit.[91] The Comptroller moved to dismiss the district court suit, arguing that the statement of grounds filed in El Paso's earlier administrative refund claim failed to adequately put the Comptroller "on notice" of El Paso's claim for telemetry units related to step-down transformers.[92]

---

88 *Hegar v. 1st Global, Inc.*, No. 03-18-00411-CV (Tex. App.—Austin Dec. 13, 2019, no pet.) (mem. op.).

89 *Hegar v. El Paso Electric Company*, No. 03-18-00790-CV (Tex. App.—Austin Aug. 13, 2020, no pet. h.) (majority opinion).

90 Tex. Tax Code § 151.318(a)(4).

91 *Hegar v. El Paso Electric Company*, slip op. at 2.

92 Slip op. at 7; see also Tex. Tax Code § 111.104 (requiring refund claim to (1) "be written"; (2) "state fully and in detail each reason or ground on which the claim is founded"; and (3) be filed before the expiration of the statute of limitations).

El Paso's original administrative filing identified the refund claim by citing and quoting in full the subsection of the manufacturing exemption statute that contains a long list of exempt support equipment:[93]

> (4) actuators, steam production equipment and its fuel, in-process flow through tanks, cooling towers, generators, heat exchangers, transformers and the switches, breakers, capacitor banks, regulators, relays, reclosers, fuses, interruptors, reactors, arrestors, resistors, insulators, instrument transformers, and telemetry units that are related to the transformers, electronic control room equipment, computerized control units, pumps, compressors, and hydraulic units, that are used to power, supply, support, or control equipment that qualifies for exemption under Subdivision (2) or (5) or to generate electricity, chilled water, or steam for ultimate sale; 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, interruptors, reactors, arrestors, 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, interruptors, reactors, arrestors, resistors, insulators, instrument transformers, and telemetry units that are related to the step-down transformers.

El Paso also cited and quoted in full other subsections of the manufacturing exemption statute and various other provisions of the tax code. The majority held that "one its own, quoting every word of all of those subsections did not suffice to put the Comptroller on notice of the legal basis of a refund claim for telemetry units related to step-down transformers."[94]

The third member of the three-justice panel issued a dissenting opinion.[95] She would have found that schedules El Paso submitted with its original statement of grounds sufficed to identify the equipment and put the Comptroller on notice of the exemption for telemetry units related to step-down transformers. These schedules "identif[ied] specific transactions involving "meters" by line items that included detailed information about the particular transaction including dates, invoice numbers, and amounts and specifically refer[red] to manufacturing exemption . . ."[96] Amicus briefs and letters have been filed by several groups, including the Texas Taxpayers and Research Association, the Texas Association of Manufacturers, and Martens, Todd & Leonard. These amicus briefs and letters ask the Third Court to re-hear the case en banc or to adopt the dissenting opinion in favor of the taxpayer.

A Taxpayer May Not Raise Entirely New Grounds After the Statute of Limitations Runs.

Mahindra USA is a distributor of farm tractors and accessories. The Comptroller audited Mahindra for franchise tax report years 2008–2011 and assessed additional taxes, penalties and interest.

---

93 Slip op. at 9.

94 Slip op. at 11.

95 *Hegar v. El Paso Electric Company*, No. 03-18-00790-CV, (Tex. App.—Austin Aug. 13, 2020, no pet. h.) (Goodwin, J., dissenting)) (pending motion for rehearing before the Third Court of Appeals).

96 Slip op. at 4–5 (Goodwin, J., dissenting).

Mahindra timely filed a petition for administrative redetermination, objecting to the audit finding with respect to its tax rate and its cost of goods sold subtraction.[97] On December 19, 2016, Mahindra submitted additional arguments, raising for the first time an issue with respect to its apportionment of sales to Texas.[98] The Comptroller issued his decision affirming his initial determination as to the tax rate and cost of goods sold issues.[99]

The Comptroller found that the apportionment issue could not be part of its administrative redetermination because they were first raised more than four years after the tax periods at issue, beyond the statute of limitations.[100]

Mahindra was dissatisfied with the result of the Comptroller's administrative proceeding, so it brough a district court protest suit challenging the assessment by raising the tax rate, cost of goods sold, and apportionment issues.[101] Mahindra argued that the district court had jurisdiction over its apportionment issue, because it was raised an contested during the pendency of the administrative redetermination proceeding.[102] Tex. Tax Code § 111.207 provides:

> (a) In determining the expiration date for a period when a tax imposed by this title may be assessed, collected, or refunded, the following periods are not considered:
>
> . . .
>
> (3) The period during which an administrative redetermination or refund hearing is pending before the comptroller.
>
> . . .
>
> (b) The suspension of a period of limitation under Subsection [(a)(3)] is limited to the issues that were contested under those subdivisions.

The court determined it lacked jurisdiction over the apportionment issue because the taxpayer had not timely raised it in an administrative proceeding, either as an offset to its assessment or as a separate refund claim, before the four year statute of limitations expired.[103] The court rejected Mahindra's argument that the Comptroller opens a "two-way door" to the re-evaluation of any issues relating to its tax payments for the years at issue.[104]

---

97 *Hegar v. Mahindra USA, Inc.*, No. 03-18-00126-CV, Slip op. at 6 (Tex. App.—Austin Feb. 28, 2020,

98 Slip op. at 6–7.

99 Slip op. at 7.

100 Slip op. at 7.

101 Slip op. at 8.

102 Slip op. at 10; Tex. Tax Code § 111.207(a)(3).

103 Slip op. at 11–17.

104 Slip op. at 16.

III. Interest Rates

Comptroller Publishes 2021 Interest Rates

Texas is in a minority of state which provide for different interest rates on tax delinquencies and overpayments.[105] The Texas Comptroller published 2021 interest rates for interest taxpayers owe on overdue payments and interest due to taxpayers for credits and refunds of tax paid in error.[106] The interest rate for overdue tax payments decreased from 5.75% in 2020 to 4.25% in 2021. The interest rate for credits or refunds decreased from 2.181% in 2020 to 0.511% in 2021.

105 Jan. 7, 2021 Texas Taxpayers and Research Association Webcast.

106 Interest Owed and Earned, TEXAS COMPTROLLER, https://comptroller.texas.gov/taxes/file-pay/interest.php (last visited Jan. 13, 2021).

TAX SECTION
State Bar of Texas

January 25, 2021

Via Federal eRulemaking Portal at *www.regulations.gov*

Internal Revenue Service
CC:PA:LPD:PR (REG-123652-18)

RE: ***Comments Regarding Proposed Regulations on the Centralized Audit Regime***

Ladies and Gentlemen:

On behalf of the Tax Section of the State Bar of Texas ("Tax Section"), I am pleased to submit the enclosed response to the request of the United States Department of the Treasury (the "Treasury Department") and the Internal Revenue Service (the "Service") for comments pertaining to proposed regulations, appearing in the Notice of Proposed Rulemaking (REG-123652-18) issued on November 24, 2020 (the "Proposed Regulations"), regarding the centralized partnership audit regime.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION 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 TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

1414 Colorado Street, Austin, TX 78701
(512) 427-1463 or (800) 204-2222

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, 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 MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend the Treasury Department and the Service for the time and thought that have been put into preparing the Proposed Regulations, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Lora G. Davis, Chair
State Bar of Texas, Tax Section

Enclosure

COMMENTS ON PROPOSED REGULATIONS
ON PARTNERSHIP CENTRALIZED AUDIT REGIME

These comments on the Proposed Regulations ("Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafters of these Comments were Lee S. Meyercord, Co-Chair of the Partnership and Real Estate Tax Committee of the Tax Section of the State Bar of Texas, and Jackson Oliver, member of the Partnership and Real Estate Tax Committee of the Tax Section of the State Bar of Texas. The Committee on Government Submissions of the Tax Section has approved these Comments. Mary A. McNulty, past Chair of the Tax Section of the State Bar of Texas and member of the Partnership and Real Estate Tax Committee of the Tax Section of the State Bar of Texas, also reviewed the Comments and provided substantive suggestions.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (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 these Comments.

Contact Persons:

Lee S. Meyercord
Partner
Thompson & Knight LLP
1722 Routh Street, Suite 1500
Dallas, TX 75201
(214) 969-1315
Lee.Meyercord@tklaw.com

Jackson Oliver
Associate
Thompson & Knight LLP
1722 Routh Street, Suite 1500
Dallas, Texas 75201
(214) 969-1530
Jackson.Oliver@tklaw.com

Date: January 25, 2021

I. INTRODUCTION

These Comments are provided in response to Treasury's and the IRS's request for comments on the Proposed Regulations. The Proposed Regulations relate to the centralized partnership audit regime (the "Centralized Audit Rules") that was enacted in the Bipartisan Budget Act of 2015 (the "BBA").[1] The Centralized Audit Rules replaced the partnership audit procedures in the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA")[2] with a centralized partnership audit regime that allows the IRS to make partnership adjustments, assessments, and collections at the partnership level.

Under Section 6241(11) of the Internal Revenue Code (the "Code"), if there are partnership-related items that involve special enforcement matters, the Secretary may issue regulations providing that the Centralized Audit Rules do not apply to such items or that such items are subject to special rules. The Proposed Regulations propose rules addressing special enforcement matters and make clarifying amendments to previously issued final regulations.

II. PARTNER-LEVEL STATUTE OF LIMITATIONS

A. Background

TEFRA allows partnership adjustments if either the partnership or partner-level statute of limitations is open.[3] By contrast, the statute of limitations for partnership adjustments under the Centralized Audit Rules is determined exclusively at the partnership level; the partner's statute of limitations is not taken into account.[4] Section 6235(a) sets forth the partnership-level limitations period and provides that no partnership adjustment may be made after the later of:

(1) the date which is 3 years after the latest of—

(A) the date the partnership return was filed,

---

[1] P.L. 114-74. Unless otherwise noted, references in these Comments to "Section" mean provisions of the Internal Revenue Code.

[2] P.L. 97-248.

[3] Section 6229 (repealed 2015). Section 6229(a) provided that the statute of limitations for adjustment of partnership items "shall not expire before" the date that is 3 years after the later of the date the partnership return was filed or the last day for filing such return. Courts concluded that the "shall not expire before" language made clear that Section 6229(a) was not an exclusive statute of limitations, and an assessment of tax attributable to a partnership item was timely as long as the period of limitations remained open under either Section 6501 (relating to a partner's statute of limitations) or Section 6229 (relating to a partnership's statute of limitations). *See, e.g.*, *Rhone-Poulenc Surfactants & Specialties, L.P. v. Comm'r*, 114 T.C. 533 (2000); *Curr-Spec Partners, L.P. v. Comm'r*, 579 F.3d 391 (5th Cir. 2009), *cert. den.*, 130 S. Ct. 3321 (2010); *AD Global Fund, LLC v. United States*, 481 F.3d 1351 (Fed. Cir. 2007); *Andantech LLC v. Comm'r*, 331 F.3d 972 (D.C. Cir. 2003); *Schumacher Trading Partners II v. United States*, 72 Fed. Cl. 95 (2006); *Grapevine Imports, Ltd. v. United States*, 71 Fed. Cl. 324 (2006); *Russian Recovery Fund, Ltd. v. United States*, 108 A.F.T.R.2d 2011-7182 (Fed. Cl. 2011).

[4] Section 6235(a).

(B) the due date of the return, or

(C) the date on which the partnership filed an administrative adjustment request (“AAR”) under Section 6227, or

(2) if the partnership requests a modification of an imputed underpayment under Section 6225(c), 270 days (plus any agreed extension) after the date the information is submitted, or

(3) if the partnership does not request modification of the imputed underpayment, 330 days (plus any agreed extension) after the date of the notice of proposed partnership adjustment (“NOPPA”).[5]

The statute of limitations on partnership adjustments may be extended by agreement.[6] In addition, an adjustment may be made at any time if the partnership files a false or fraudulent return or no return.[7] The limitations period in (1) above is extended from three years to six years if the partnership makes a substantial omission from gross income.[8]

B. Proposed Regulation

Proposed Regulation Section 301.6241-7(f) allows the IRS to make partnership adjustments after the partnership-level statute of limitations has expired if the *partner's* statute of limitations is open and either (1) the partner has control over the partnership (as determined under Sections 267(b) and 707(b)); or (2) the partner has extended the partner's statute of limitations under Section 6501 and the extension expressly states that the partner is extending the time to adjust and assess any tax attributable to partnership-related items for the taxable year.

C. Discussion

The Proposed Regulations appear inconsistent with Congress's clear directive in the Centralized Audit Rules to determine the statute of limitations for partnership adjustments exclusively at the partnership level. Section 6221(a) specifies that “[a]ny adjustment to a partnership-related item shall be determined, and any tax attributable thereto shall be assessed and collected, and the applicability of any penalty, addition to tax, or additional amount which relates

[5] *See also* Section 6232(b) (no assessment may be made before the 90th day after the notice of final partnership adjustment (“FPA”) is mailed and—if a petition is filed in the Tax Court—the decision of the court has become final).

[6] Section 6235(b).

[7] Section 6235(c)(1), (3).

[8] Section 6235(c)(2).

to an adjustment to any such item shall be determined, *at the partnership level*...."[9] Thus, the partner's statute of limitations is irrelevant to partnership adjustments.

We respectfully suggest that the IRS should not extend the statute of limitations for partnership adjustments beyond what Congress has prescribed. Statutes of limitations are strictly construed in accordance with their express terms.[10] For example, in *Brockamp*, the Supreme Court found that the statutory limitations period for tax refund claims did not contain an implied equitable exception because the statute "sets forth its limitations in a highly detailed technical manner, that linguistically speaking, cannot easily be read as containing implicit exceptions."[11] Likewise, Section 6235 contains detailed limitations for the time period in which partnership adjustments may be made. Unlike TEFRA, the statutory language of Section 6235 nowhere suggests that the statute of limitations for partnership adjustments may be determined at the *partner* level.[12] Section 6235 sets forth explicit exceptions to its general time limits, and those specific exceptions do not include whether a controlling partner's statute of limitations is open or a partner has agreed to extend its statute of limitations.[13]

1. *Legislative History Does Not Support Determining the Statute of Limitations at the Partner Level*

The legislative history of Section 6235 further confirms that Congress intended the statute of limitations for partnership adjustments to be determined exclusively at the partnership level.[14] When Congress revised certain provisions of the Centralized Audit Rules after their enactment, it chose not to add a partner-level statute of limitations, even though it addressed other statute of limitations issues.[15] As part of the Tax Technical Corrections Act of 2018 ("TTCA"), Congress

---

[9] Section 6221(a) (emphasis added).

[10] *Badaracco v. Comm'r*, 464 U.S. 386, 391–92 (1984) ("…even were we free to do so, there is no need to twist § 6501(c)(1) beyond the contours of its plain and unambiguous language in order to comport with good policy….").

[11] *United States v. Brockamp*, 519 U.S. 347, 350 (1997).

[12] *Lamie v. U.S. Trustee*, 540 U.S. 526, 542 (2004) ("If Congress enacted into law something different from what it intended, then it should amend the statute to conform to its intent.").

[13] *See* Section 6235(b) (extension by agreement) and Section 6235(c) (fraud).

[14] The legislative history summarizes the statute of limitations rules and never suggests an exception if the partner's statute of limitations is open or the partner agreed to an extension. STAFF OF THE JOINT COMM. ON TAX'N, GENERAL EXPLANATION OF THE TAX LEGISLATION ENACTED IN 2015 (JCS-1-16), at 75–76 (2016). Instead, the legislative history makes clear that it is the *partnership* that "may consent to an extension of time within which a partnership adjustment may be made." *Id*. at 75. Further, the legislative history reiterates that under the Centralized Audit Rules, any partnership adjustments are "determined at the *partnership level*" and "[a]ny tax attributable to these items is assessed and generally is collected at the *partnership level*." *Id*. at 62 (emphasis added).

[15] Corrections were made to the Centralized Audit Rules by the Protecting Americans from Tax Hikes Act of 2015, Pub. L. No. 114-113, Div. Q, § 411, 129 Stat. 2241 (2015), effective as if included in the BBA. Additional corrections and modifications were made by the TTCA included in the Consolidated Appropriations Act, 2018, Pub. L. No. 115-66, Div. U, Title II, 132 Stat. 348 (2018), effective as if included in the BBA.

explicitly addressed special statutes of limitations for taxes imposed by a chapter other than Chapter 1 in the same Section of the Code that includes special enforcement provisions.[16] The TTCA also fixed a statute of limitations glitch that would have allowed the IRS to issue a NOPPA to revive an otherwise closed statute of limitations.[17] Despite Congress's focus on statute of limitations issues in the technical corrections, Congress declined to enact any provision to alter the rule in Section 6235 that the statute of limitations for partnership adjustments is determined exclusively at the partnership level.

2. *Preamble Does Not Support Departing from the Statute*

The preamble to the Proposed Regulations suggests that IRS resource issues in partner-level audits and tiered partnership structures present "special enforcement considerations" under Section 6241(11)(B)(vi) that justify application of a partner-level statute of limitations for partnership adjustments in certain circumstances. Specifically, the preamble states that Proposed Regulation Section 301.6241-7(f) is necessary because certain "partnership issues may only become apparent at a future date or during an examination of a partner, which can frustrate the IRS's ability to allocate resources and examine taxpayers timely, especially in situations where the partnership structure includes many related and controlled entities."[18] Therefore, the preamble argues for a partner-level statute of limitations to carry out the results of audits of complex multi-tiered partnership structures.[19]

We respectfully suggest that the "special enforcement considerations" in the preamble do not warrant extending the statute of limitations by regulation, particularly when such regulation appears inconsistent with the statute and its related legislative history. We respectfully note that the statute and related legislative history do not suggest that control or a partner's agreement to extend its statute of limitations should result in a longer limitations period for partnership adjustments. As courts have recognized, "[s]tatutes of limitation frequently involve some hardship, but the alleviation of that hardship is a matter of policy for the Congress."[20]

---

[16] *See* Section 6241(9).

[17] Prior to the amendment by the TTCA, the time period when a NOPPA must be issued was not specified. The TTCA amended Section 6231(b)(1) to provide that any NOPPA must be issued within the three-year period in Section 6235(a)(1). TTCA, Pub. L. No. 115-66, Div. U, Title II, 132 Stat. 348 (2018). Therefore, the NOPPA must be issued within three years of the later of the date the partnership return was filed, the date the return was due, or the date the partnership filed an AAR. Section 6231(b)(1). As a result, the IRS cannot issue a NOPPA to revive an otherwise closed statute of limitations. STAFF OF THE JOINT COMM. ON TAX'N, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE HOUSE AMENDMENT TO THE SENATE AMENDMENT TO H.R. 1625 (JCX-6-18), at 40 (2018).

[18] Preamble to Prop. Treas. Reg. Section 301.6241-7(f), 85 Fed. Reg. 74,940 (Nov. 24, 2020).

[19] Preamble to Prop. Treas. Reg. Section 301.6241-7(f), 85 Fed. Reg. 74,940 (Nov. 24, 2020).

[20] *Kreiger v. United States*, 539 F.2d 317, 322 (3d Cir. 1976); *see also Rothensies v. Electric Storage Battery Co.,* 329 U.S. 296, 300 (1946) (citing *Chase Securities Corp. v. Donaldson*, 325 U.S. 304, 314 (1937)) (Statutes of limitations "…are by definition arbitrary, and their operation does not discriminate between the just and unjust claim, or the [a]voidable and unavoidable delay.").

In addition, the issues surrounding multi-tiered partnership structures were a significant impetus for enacting the Centralized Audit Rules, and Congress chose not to enact a partner-level statute of limitations despite its familiarity with the issues presented by such structures.[21] Proposed Regulation Section 301.6241-7(f) is not limited to tiered partnerships, but rather applies any time a partner controls a partnership or any time a partner (even a direct partner) extends its period of limitations and includes partnership adjustments in that extension. Thus, the application of Proposed Regulation Section 301.6241-7(f) extends well beyond the tiered partnership structures that present the "special enforcement considerations" discussed in the Preamble.

C. Recommendation

We respectfully recommend that the Proposed Regulations be amended to strike Proposed Regulation Section 301.6241-7(f).

III. EFFECTIVE DATE OF RULE THAT QSUBS ARE NOT ELIGIBLE PARTNERS

A. Background and Proposed Regulation

Partnerships with fewer than 100 partners may generally elect out of the Centralized Audit Rules if all of the partners are "eligible partners" (*e.g.*, individuals or corporate partners).[22] Proposed Regulation Section 301.6221(b)-1(b)(3)(ii)(G) provides that a qualified subchapter S subsidiary ("QSub") is not an eligible partner for purposes of the election out of the Centralized Audit Rules. This provision is proposed to be effective for partnership tax years ending after November 20, 2020.[23]

B. Discussion

The parent of a QSub, an S corporation, is deemed to directly own all of the assets, liabilities, and other tax items of its QSub subsidiaries. The proposed regulations therefore treat a QSub like a disregarded entity and not an eligible partner. While IRS Notice 2019-06 foreshadowed this treatment, it also notified taxpayers that the regulations would nevertheless allow certain partnerships with a QSub partner to make the election out of the Centralized Audit Rules.[24] However, the Proposed Regulations do not allow any partnerships with a QSub partner to elect out. As a result, at the time the Proposed Regulations were published in the Federal Register, the opportunity for partnerships with QSub partners to restructure in order to retain the ability to opt out of the Centralized Audit Rules was already foreclosed.

---

[21] STAFF OF THE JOINT COMM. ON TAX'N, DESCRIPTION OF CERTAIN REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2016 BUDGET PROPOSAL (JCS-2-15), at 264 – 66 (2015) (Explaining that the Centralized Audit Rules are intended to address several of the difficulties under TEFRA including those that arise "in the case of tiered partnerships or partnerships with other types of passthrough partners.").

[22] Section 6221(b)(1).

[23] Prop. Reg. Section 301.6221(b)-1(f).

[24] Notice 2019-06, 2019-3 I.R.B. 350.

C. Recommendation

We respectfully recommend that Proposed Regulation Section 301.6221(b)-1(f) be amended to provide that (b)(3)(ii)(G) is effective for partnership tax years ending after the date the regulations are finalized and published in the Federal Register. This will allow partnerships with QSub partners sufficient time to restructure if they would like to be eligible to elect out of the Centralized Audit Rules for the tax year when the Proposed Regulations become effective.

IV. PARTNERSHIP ADJUSTMENTS IN PARTNER-LEVEL AUDIT

A. Proposed Regulation

Proposed Regulation Section 301.6241-7(b) allows the IRS to make an adjustment to a partnership-related item during the audit of a partner (as opposed to the partnership) if the partnership-related item is based in whole or in part on information provided by the partner. The Proposed Regulations illustrate this provision with a lengthy example (the "Example").[25]

This provision is proposed to be effective retroactively, as it applies to partnership tax years beginning after December 20, 2018.[26]

B. Discussion

We respectfully suggest that the scope of this rule is unclear because there is no clear indication of when the IRS can trigger this provision and avoid the Centralized Audit Rules with no notice to the partnership. The only apparent limitation is that the treatment of the partnership-related item must be "based in whole or in part on information provided by the person whose return is being examined."[27] We respectfully note that the "in part" language is vague and could be construed to encompass a wide variety of partnership-related items. As explained above, making partnership adjustments in a partner-level audit appears inconsistent with Congress's clear directive that partnership adjustments be determined "at the partnership level."[28] Therefore, we respectfully suggest that any departure from the Centralized Audit Rules should be as narrowly prescribed as possible, and should be available only in circumstances where there is a clear justification for the departure.

The Example addresses the sale of a partnership interest by A to B. A originally acquired its partnership interest by contributing an asset to the partnership.[29] When auditing A, the IRS adjusts the basis of the partnership asset. First, we respectfully note that it is unclear why the partnership adjustment is made in the Example. Proposed Regulation Section 301.6241-7(h)(2) provides that any partnership adjustments that are made outside of the Centralized Audit Rules are

---

[25] Prop. Reg. Section 301.6241-7(b)(2).

[26] Prop. Reg. Section 301.6241-7(j)(2).

[27] Prop. Reg. Section 301.6241-7(b)(1)(iii).

[28] Section 6221(a) (emphasis added).

[29] Prop. Reg. Section 301.6241-7(b)(2).

not binding on any person that is not a party to the proceeding. In the Example, only A was a party to the proceeding, and A is no longer a partner in the partnership. Therefore, under Proposed Regulation Section 301.6241-7(h)(2), the partnership adjustment is not binding on any of the partners in the partnership.

Second, assuming the partnership adjustment is binding on the partners in the partnership (contrary to Proposed Regulation Section 301.6241-7(h)(2)), the Example does not explain how a Section 754 election would interact with the adjustment to the partnership asset made during A's audit. If a Section 754 election was in effect when A sold its interest to B, the partnership's basis in the asset would have been adjusted to fair market value under Section 743 as to B. This adjustment recognizes that A was taxed on the gain on the sale of its partnership interest and that B should not be taxed again on the same gain. We respectfully suggest that, when auditing A, the IRS should not be able to adjust the basis of the asset at the partnership level and "undo" the Section 754 election. The adjustment at the partner level results in additional gain that is taxed to A. The Section 754 election already adjusted the basis of the asset at the partnership level to its fair market value as to B.

We respectfully suggest further that the retroactivity of Proposed Regulation Section 301.6241-7(b) is unnecessary because the partnership-level statute of limitations has not run for tax years beginning after December 20, 2018. Therefore, the IRS can open a partnership-level audit to make the adjustment to the partnership-related item if warranted.

C. Recommendations

We respectfully recommend that the Proposed Regulations be amended to strike Proposed Regulation Section 301.6241-7(b) because it appears inconsistent with the purpose of the Centralized Audit Rules. If Proposed Regulation Section 301.6241-7(b) is retained, we respectfully recommend that the Example be revised to (i) clarify that the partnership did not have a Section 754 election in effect and that if it did, the partnership's basis in the asset would not be adjusted and (ii) include a description of the application of Proposed Regulation Section 301.6241-7(h)(2) in connection with the Example. We also respectfully recommend that Proposed Regulation Section 301.6241-7(b), if retained, not be retroactive but be subject to the same effective date of the other special enforcement matters under Proposed Regulation Section 301.6241-7(j)(1).

V. NON-INCOME ADJUSTMENTS THAT DO NOT RESULT IN AN IMPUTED UNDERPAYMENT

A. Background and Proposed Regulation

Section 6225(a)(2) provides that adjustments that do not result in an imputed underpayment shall be taken into account by the partnership in the adjustment year. Proposed Regulation Section 301.6225-3(b)(8) provides that non-income adjustments (*i.e.*, adjustments to non-income items, such as partnership assets, liabilities, and capital accounts) are taken into account by adjusting the item on the partnership's adjustment year return but only to the extent the item would appear on the adjustment year return without regard to the adjustment. The Proposed Regulations provide an example in which the IRS conducts an audit in 2022 of a partnership's 2020 tax year and adjusts the basis of a partnership asset by $10. The example includes this positive adjustment and a negative adjustment to credits when determining whether an imputed underpayment results. Because the adjustments do not result in an imputed underpayment, "the partnership takes into account the $10 adjustment to Asset on its 2022 return by reducing its basis in Asset by $10."[30]

B. Discussion

In the example, the non-income adjustment is included as a positive adjustment under Treasury Regulation Section 301.6225-1(d)(2)(iii)(A) in determining whether there is an imputed underpayment. Including this non-income adjustment in the imputed underpayment determination as a positive adjustment could result in the recognition of gain on an asset before the asset has been disposed of or sold. We respectfully suggest such a result is inconsistent with general federal income tax principles that gain or loss on an asset is not taken into account until there has been a realization event that results in the recognition of gain or loss.[31]

In addition, we respectfully note that treating the basis adjustment as a positive adjustment may lead to double taxation under Proposed Regulation Section 301.6241-7(b). Consider for example a partner-level audit in which the IRS determines that a partner's basis in a contributed asset was $30 rather than $50, and therefore there is an additional $20 of gain on the partner's sale of her partnership interest. Under Proposed Regulation Section 301.6241-7(b), the IRS can also adjust the partnership's basis in the contributed asset from $50 to $30. This $20 non-income adjustment is treated as a positive adjustment that would give rise to an imputed underpayment because there are no negative adjustments that could offset the positive adjustment. As a result, the partner would pay tax on the $20 of additional gain on the sale of the partnership interest, and the partnership would pay tax on the $20 basis adjustment in an imputed underpayment. We respectfully suggest that the IRS and Treasury consider either (i) excluding non-income adjustments from the computation of the imputed underpayment entirely or (ii) treating the amount of the adjustment as zero. Either approach avoids both the acceleration of gain when there has been no realization and recognition event and the potential double taxation under Proposed Regulation Section 301.6241-7(b).

We also respectfully note that it is not clear whether the positive adjustment in the example only corrects the asset's basis in 2022 or whether the partnership must also realize and recognize gain on the $10 positive adjustment in 2022 (the adjustment year). We respectfully suggest that requiring the partnership to realize and recognize gain on the $10 basis adjustment in the adjustment year would be inconsistent with general federal income tax principles that do not tax gain or loss until there has been a realization event that results in the recognition of gain or loss.[32]

C. Recommendations

We respectfully recommend that the Proposed Regulations be revised to provide that non-income adjustments are not taken into account in determining whether there is an imputed

[30] Prop. Reg. Section 301.6225-3(d)(Ex. 3).

[31] Section 1001(a), (c).

[32] *Id*.

underpayment. Further, we respectfully recommend that when these non-income adjustments are made in the adjustment year, the item is corrected but gain is not recognized until the partnership would otherwise recognize gain. We also respectfully recommend that the cross-references in the example be revised to refer to Treasury Regulation Section 301.6225-1(d)(2) and 301.6225-1(f) in their entirety. In addition, we respectfully recommend that the Proposed Regulations include examples illustrating how adjustments to other non-income items like partnership liabilities and capital accounts are taken into account.

VI. CHAPTER 1 PENALTIES AND TAXES IMPOSED ON THE PARTNERSHIP

A. Proposed Regulation

Proposed Regulation Section 301.6241-7(g) allows the IRS to make adjustments outside of the Centralized Audit Rules to any Chapter 1 tax, penalties, additions to tax, or additional amounts imposed on the partnership and for which the partnership (as opposed to the partners) are liable. This provision also allows the IRS to adjust any partnership-related item as part of that determination.[33]

B. Discussion

Congress intended for the Centralized Audit Rules to apply to all Chapter 1 taxes, which include all normal taxes and surtaxes (Sections 1 through 1400Z-2). Such Chapter 1 taxes, penalties, and additions to tax are imposed on partners, not partnerships.[34] Additionally, Treasury Regulation Section 301.6241-6 already addresses taxes outside of Chapter 1. Thus, we respectfully suggest that the purpose and scope of this provision are unclear.

C. Recommendations

We respectfully recommend that Proposed Regulation Section 301.6241-7(g) be amended to make its purpose and scope clearer and that examples be added.

[33] Prop. Reg. Section 301.6241-7(g).

[34] *See, e.g.*, Section 701 (expressly states that "[a] partnership as such shall not be subject to the income tax imposed by this chapter…" and instead the "…partners shall be liable for income tax only in their separate or individual capacities.").

TAX SECTION OF

THE STATE BAR OF TEXAS

Updated 3/28/2021

2020 – 2021 CALENDAR

June 2020	
Monday 6/1/20	**SBOT Fiscal Year Begins**
Thurs - Fri 6/25-26/20	**SBOT Annual Meeting** Virtual via Zoom
Friday 6/26/20	**Award Presentation to Council and Chairs During Tax Section Annual Meeting Program and Tax Section Annual Meeting Program**
Tuesday 6/30/20	**Deadline to receive nominations for 2020-2021 Leadership SBOT class**
July 2020	
Friday 7/3/20	**July 4th (Holiday)**
Wednesday 7/15/20	**Tax Section Budget Deadline** Budget must be submitted to Executive Direction of State Bar of Texas
Thurs - Sat 7/16-18/20	**Texas Bar College - Summer School 2020** Texas Bar CLE Webcast
Wed – Tues 7/29 – 8/4/20	**ABA Annual Meeting** Convening for Justice – Virtual Meeting
August 2020	
Wednesday 8/5/20	**Officers' Retreat** Via Zoom 8:30 a.m.
Wednesday 8/5/20	**First Wednesday Tax Update** 12:00 p.m.
Monday 8/10/20	**SBOT Chair and Treasurer Training** Via Zoom 10:30 a.m. – 2:30 p.m.
Friday 8/21/20	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 1-800-270-2297 Conference Code: 15109392 11:00 a.m.
Thurs – Fri 8/27-28/20	**Tax Law 2020: A Practical Guide to Tax Law in the Real World Online CLE** Texas Bar CLE Webcast

Sept 2020	
Wednesday 9/2/20	**First Wednesday Tax Update** 12:00 p.m.
Wednesday 9/2/20	**Officers' Call** 1:00 p.m.
Monday 9/7/20	**Labor Day (Holiday)**
Thursday 9/10/20	**SBOT Executive Committee Meeting**
Friday 9/11/20	**Submission Deadline – Texas Tax Lawyer (Fall Edition)** Submit to TTL Editor: Aaron Borden email: aaron.borden@us.gt.com
Friday 9/11/20	**Meeting of Council, Committee Chairs, and Committee Vice Chairs** Via Zoom 9:00 a.m. – 11:30 a.m.
Thursday 9/17/20	**Posting deadline for agenda of September SBOT Board of Directors Meeting**
Friday 9/18/20	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 1-800-270-2297 Conference Code: 15109392 11:00 a.m.
Friday 09/18/20	**Outreach to Law Schools (not yet scheduled)**
Fri-Sun 9/18–20/20	**Rosh Hashanah (Religious Holiday)**
Monday 9/21/20	**Tax Court Pro Bono Calendar Call-Houston (Regular Case)**
Mon-Fri 9/21-25/20	**ABA Business Law Section Annual Meeting** Virtual
Thursday 9/24/19	**Deadline for Chair to Appoint Nominating Committee** (90 days after Annual Meeting per Bylaws Section 4.1)
Thurs-Fri 9/24-25/20	**SBOT Board of Directors Meeting**
Sun-Mon 9/27-28/20	**Yom Kippur (Religious Holiday)**
Tues. 9/29/20	**Zooming into Tax Court CLE**
Tues. 9/29/20	**Law School Outreach - SMU**

9/29-10/2/20	**ABA Tax Section 2020 Fall Meeting** online
Oct 2020	
Wednesday 10/7/20	**First Wednesday Tax Update** 12:00 p.m.
Wednesday 10/7/20	**Officers' Call** 1:00 p.m.
Monday 10/12/20	**Columbus Day (Holiday)**
Tues-Fri 10/13-16/20	**Tax Court Pro Bono Calendar Call –Houston (Small Case)**
Friday 10/16/20	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 1-800-270-2297 Conference Code: 15109392 11:00 a.m.
Monday 10/19/20	**Tax Court Pro Bono Calendar Call-Dallas (Small Case)**
Mon - Thurs 10/19-22/20	**Council on State Taxation (COST) 51st Annual Meeting** Webinar
Friday 10/23/20	**Council of Chairs Meeting** 10:30 a.m. – 2:30 p.m.
Fri - Sat 10/23-24/20	**National Association of State Bar Tax Sections ("NASBTS") Annual Meeting** (members may attend at their own expense) TBD
Monday 10/26/20	**Tax Court Pro Bono Calendar Call-Las Vegas (Regular Case)**
Saturday 10/31/20	**Insurance Renewal is Due** **Note Premium Paid by Big Bar!**
Nov 2020	
Monday 11/2/20	**Annual Meeting Deadline** Submit date and time preference for CLE programs, section meetings, council meetings, socials, and special events.
Wednesday 11/4/20	**First Wednesday Tax Update** 12:00 p.m.
Wednesday 11/4/20	**Officer's Call** 1:00 p.m.
Wed - Thurs 11/4-5/20	**Austin Chapter CPA Annual Tax Conference** Norris Conference Center, Austin, Texas

Thursday 11/5/20	**State Bar of Texas Pro Bono Workgroup Meeting** Via Zoom 10:00 a.m. - 1:00 p.m.
Friday 11/6/20	**Meeting of Council** Via Zoom 9:00 a.m. – 11:00 a.m.
Monday 11/9/20	**Tax Court Pro Bono Calendar Call-Houston (Regular Case)**
Monday 11/9/20	**Tax Court Pro Bono Calendar Call-Dallas (Regular Case)**
Wednesday 11/11/20	**Veterans Day (Holiday)**
Friday 11/20/20	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 1-800-270-2297 Conference Code: 15109392 11:00 a.m.
Thursday 11/26/20	**Thanksgiving Day (Holiday)**
Dec. 2020	
Wednesday 12/2/20	**First Wednesday Tax Update** 12:00 p.m.
Wednesday 12/2/20	**Officers' Call** 1:00 p.m.
Wed - Thurs 12/2-3/20	**UT Law 67th Annual Taxation Conference** Virtual
Tues - Wed 12/8-9/20	**Texas Taxpayers and Research Association (TTARA) Annual Meeting** Virtual - TBD
Sun - Mon 12/10-18/20	**Hanukkah (Other Holiday)**
Thurs-Sat 12/10-12/20	**ABA Section of Taxation National Institute: Criminal Tax Fraud/Tax Controversy** Wynn Resort, Las Vegas, NV
Friday 12/18/20	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 1-800-270-2297 Conference Code: 15109392 11:00 a.m.

Friday 12/25/20	**Christmas (Holiday)**
Jan. 2021	
Friday 1/1/21	**New Year's Day (Holiday)**
Monday 1/4/21	**Annual Meeting Deadline** Submit programming for the registration brochure, CLE topics, speakers, and speaker contact information and firm.
Tues-Thurs 1/5-7/2021	**Adopt-A-Base Training – Fort Bliss**
Wednesday 1/6/21	**Officers' Call** 1:00 p.m.
Mon-Wed 1/11-13/2021	**Adopt-A-Base Training – Fort Sam**
Tuesday 1/12/21	**SBOT Executive Committee Meeting**
Thursday 1/14/21	**Posting deadline for agenda of January SBOT Board of Directors Meeting**
Friday 1/15/21	**Nomination Period Opens for 2021 Outstanding Texas Tax Lawyer Award** • Nominations due April 1, 2021 • Nomination forms to be posted on website • Submit nomination forms to Tax Section Secretary: Henry Talavera
Friday 1/15/21	**Law Student Scholarship Applications Open** • Applications due April 16, 2021 • Applications forms to be posted on website
Friday 1/15/21	**Meeting of Council, Committee Chairs, and Committee Vice Chairs** Virtual
Monday 1/18/21	**Martin Luther King Jr. Day (Holiday)**
Thurs-Fri 1/21-22/21	**SBOT Board of Directors Meeting** Virtual
Friday 1/22/21	**Submission Deadline – Texas Tax Lawyer (Winter Edition)** Submit to TTL Editor: Aaron Borden email: aaron.borden@us.gt.com
Monday 1/25/21	**Tax Court Pro Bono Calendar Call-San Antonio (Regular Case)**
Wed-Fri 1/27-29/21	**Adopt-A-Base Training – Fort Hood**
Mon-Fri 1/25-29/21	**ABA Section of Taxation Midyear Meeting** Virtual

Feb. 2021	
Monday 2/1/21	**Register and make guest room reservations for Annual Meeting (www.texasbar.com/annualmeeting) –** ***Moved to Virtual Meeting***
Wednesday 2/3/21	**First Wednesday Tax Update** 12:00 p.m.
Wednesday 2/3/21	**Officers' Call** 1:00 p.m.
Thurs-Fri 2/4-5/21	**SBOT Tax Section Tax Law in a Day CLE** Virtual
Thursday 2/4/21	**Law School Outreach St. Mary's University** Virtual
Friday 2/5/21	**Law School Outreach at Texas A & M University** virtual
Monday 2/8/21	**Tax Court Pro Bono Calendar Call-Lubbock (Hybrid Case)**
Tuesday 2/9/21	**Law School Outreach at University of Texas** Virtual
Monday 2/15/21	**President's Day (Holiday)**
Wed – Mon 2/17-22/21	**ABA Midyear Meeting** Virtual
Thursday 2/18/21	**Law School Outreach at Texas Tech** Virtual
Friday 2/19/21	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 1-800-270-2297 Conference Code: 15109392 11:00 a.m.
Monday 2/22/21	**Annual Meeting Deadline –** ***Cancelled - Moved to Virtual Meeting*** Order special awards, council and chair plaques, food and beverage, and AV.
Friday 02/26/21	**Council of Chairs Meeting and Section Representative Election** Via Zoom 10:30 a.m. – 2:30 p.m.
March 2021	
Monday 3/1/21	**Nomination Deadline** Tax Section Chair-Elect, Secretary, Treasurer, and 3 Elected Council Members SBOT and TYLA President-Elect and Director positions
Monday 3/1/21	**Tax Court Pro Bono Calendar Call-San Antonio (Small Case)**

Wednesday 3/3/21	**First Wednesday Tax Update** 12:00 p.m.
Wednesday 3/3/21	**Officers' Call** 1:00 p.m.
Thursday 3/11/21	**Nominating Committee Conference Call** Via Zoom 9:00 a.m.
Friday 3/19/21	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 1-800-270-2297 Conference Code: 15109392 11:00 a.m.
Monday 3/22/21	**Tax Court Pro Bono Calendar Call-Dallas (Regular Case)**
TBD	**2021 State Bar of Texas Property Tax Committee Meeting & Legal Seminar**
Monday 3/29/21	**Tax Court Pro Bono Calendar Call-Houston (Regular Case)**
Monday 3/29/21	**Tax Court Pro Bono Calendar Call-El Paso (Hybrid Case)**
Sat-Sat 3/27-4/3/21	**Passover (Religious Holiday)**
Tuesday 3/30/21	**Nominating Committee Report Due to Council** (10 days prior to meeting preceding Annual Meeting per Bylaws Section 4.1)
April 2021	
Thursday 4/1/21	**Nominations for Outstanding Texas Tax Lawyer Due to Henry Talavera** Email**:** HTalavera@Polsinelli.com
Fri, Sun 4/2, 4/21	**Good Friday, Easter (Religious Holiday)**
Monday 4/5/21	**Deadline for section year-end reports for publication in the Texas Bar Journal**
Monday 4/5/21	**Annual Meeting Deadline** Course materials for app, CLE articles, PowerPoints, speaker bios and photos
Wednesday 4/7/21	**First Wednesday Tax Update** 12:00 p.m.
Wednesday 4/7/21	**Officers' Call** 1:00 p.m.

Friday 4/9/21	**Meeting of Council** Via Zoom 9:00 a.m. – 11:00 a.m. **Note: Council Vote and Selection of Recipient of 2021 Outstanding Texas Tax Lawyer Award**
Friday 4/9/21	**Submission Deadline – Texas Tax Lawyer (Spring Edition)** Submit to TTL Editor: Aaron Borden email: aaron.borden@us.gt.com
Monday 4/12/21	**Annual Meeting Deadline** Submit any final programming changes for onsite event guide, CLE topic titles, speakers, speaker contact information and firm
Thurs – Fri 4/15-16/21	**SBOT Board of Directors Meeting** Via Zoom Announcement of Chair of the Board Election results
Friday 4/16/21	**Law Student Scholarship Application Deadline**
Friday 4/16/21	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 1-800-270-2297 Conference Code: 15109392 11:00 a.m.
Friday 4/23/21	**Advanced Tax Law Webinar: A Deep Dive into the Carried Interest Regulations** 10:30 a.m. – 2:30 p.m.
May 2021	
Saturday 5/1/21	**National Law Day**
Wednesday 5/5/21	**First Wednesday Tax Update** 12:00 p.m.
Wednesday 5/5/21	**Officers' Call** 1:00 p.m.
Thurs – Sat 5/13-15/21	**ABA Section of Taxation May Meeting** Virtual
Sun – Mon 5/16-17/21	**Shavuot (Religious Holiday)**
Monday 5/17/21	**Annual Meeting - Last Day of Early Bird Registration**
Friday 5/21/21	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 1-800-270-2297 Conference Code: 15109392 11:00 a.m.

Friday 5/21/21	**Deadline to make guest room reservations for Annual Meeting at discounted rate (www.texasbar.com/annualmeeting)** ***Moved to Virtual Meeting***
Monday 5/30/21	**Deadline to Deliver to Members or Post on Tax Section Website Notice of Annual Meeting** (20 days prior to Annual Meeting per Bylaws Section 7.1) **Deadline to Deliver to Members or Post on Tax Section Website Nominating Committee Report** (20 days prior to Annual Meeting per Bylaws Section 4.1)
Monday 05/31/21	**Memorial Day (Holiday)**
June 2021	
6/1/21	**SBOT Fiscal Year begins**
Wednesday 6/2/21	**First Wednesday Tax Update** 12:00 p.m.
Wednesday 6/2/21	**Officers' Call** 1:00 p.m.
Wed – Fri 6/1-4/21	**Annual Texas Federal Tax Institute** Virtual Meeting
Thursday 6/17/21	**2021 Tax Section Presentation of Outstanding Texas Tax Lawyer** TBD
Thurs – Fri 6/17-18/21	**SBOT Annual Meeting** Via Zoom
	2021 Tax Section Annual Meeting Program and Award Presentation to Council and Chairs TBD
Friday 6/18/21	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 1-800-270-2297 Conference Code: 15109392 11:00 a.m.

Other Events Not Yet Scheduled	
Future Annual Meeting Dates and Locations	
Thurs-Fri 6/9-10/22	**State Bar of Texas Annual Meeting** Marriott Marquis, Houston
Thurs-Fri 6/22-23/23	**State Bar of Texas Annual Meeting** JW Marriott, Austin
Thurs-Fri 6/20-21/24	**State Bar of Texas Annual Meeting** Hilton Anatole, Dallas

Bylaws Section 7.4: Notice of regular meetings shall be delivered to the Council members by electronic mail, U.S. mail, overnight delivery service, or posting on the Section's website (or combination thereof) at least ten days prior to the date designated for such regular meeting.

TAX SECTION

STATE BAR OF TEXAS

LEADERSHIP ROSTER

2020-2021

Officers

Lora G. Davis (Chair)
Davis Stephenson, PLLC
100 Crescent Court, Suite 440
Dallas, Texas 75201
(214) 396-8801
lora@davisstephenson.com

Dan Baucum (Chair-Elect)
Daniel Baucum Law PLLC
8150 N. Central Expressway, 10th Floor
Dallas, Texas 75206
(214) 969-7333
dbaucum@baucumlaw.com

Henry Talavera (Secretary)
Polsinelli PC
2950 N. Harwood, Suite 2100
Dallas, Texas 75201
(214) 661-5538
htalavera@polsinelli.com

Robert C. Morris (Treasurer)
Norton Rose Fulbright US LLP
1301 McKinney, Suite 5100
Houston, Texas 77010
(214) 651-8404
robert.morris@nortonrosefulbright.com

Section Representative to the State Bar Board

David Calvillo
Chamberlain, Hrdlicka, White, Williams, & Aughtry, PC
1200 Smith Street, Suite 1400
Houston, Texas 77002-4130
(713) 654-9629
David.Calvillo@chamberlainlaw.com

Appointed Council Members

Sam Megally
Government Submissions (COGS) Chair
K&L Gates, LLP
1717 Main Street, Suite 2800
Dallas, Texas 75201
(214) 939-5491
sam.megally@klgates.com

Abbey B. Garber
CLE Co-Chair
Thompson & Knight
1722 Routh Street, Suite 1500
Dallas, Texas 75201
(214) 969-1640
Abbey.Garber@tklaw.com

Michael Threet
CLE Co-Chair
Haynes and Boone, LLP
2323 Victory Avenue, Suite 700
Dallas, Texas 75219
(214) 651-5091
michael.threet@haynesboone.com

Amanda Traphagan
CLE Co-Chair
Seay Traphagan, PLLC
807 Brazos St., Suite 304
Austin, Texas 78701
(512) 582-0120
atraphagan@seaytaxlaw.com

Aaron Borden
Newsletter Editor
Grant Thornton
1717 Main Street, Suite 1800
Dallas, Texas 75201
(214) 561-2604
Aaron.Borden@us.gt.com

Rachael Rubenstein
Pro Bono Co-Chair
Clark Hill Strasburger, LLP
2301 Broadway Street
San Antonio, Texas 78215
(210) 250-6006
rachael.rubenstein@clarkhillstrasburger.com

Robert D. Probasco
Pro Bono Co-Chair
Texas A&M University School of Law
307 W. 7th Street, Suite LL50
Fort Worth, Texas 76102
(214) 335-7549
probasco@law.tamu.edu

Robert C. Morris
Leadership Academy Chair
Norton Rose Fulbright US LLP
1301 McKinney, Suite 5100
Houston, Texas 77010
(713) 651-8404
robert.morris@nortonrosefulbright.com

Elected Council Members

Ira Lipstet
Term expires 2021
DuBois, Bryant & Campbell, LLP
303 Colorado, Suite 2300
Austin, Texas 78701
(512) 381-8040
ilipstet@dbcllp.com

Jim Roberts
Term expires 2021
Glast, Phillips and Murray, PC
14801 Quorum Drive, Suite 500
Dallas, Texas 75254
(972) 419-7189
jvroberts@gpm-law.com

Laurel Stephenson
Term expires 2021
Davis Stephenson, PLLC
100 Crescent Ct., Suite. 440
Dallas, Texas 75201
(214) 396-8802
laurel@davisstephenson.com

Renesha Fountain
Term expires 2022
Chamberlain, Hrdlicka, White, Williams & Aughtry, PC
1200 Smith Street, Ste. 1400
Houston, Texas 77002
(713) 658-2517
renesha.fountain@chamberlainlaw.com

Abbey Garber
Term expires 2022
Thompson & Knight
1722 Routh Street, Suite 1500
Dallas, Texas 75201
(214) 969-1640
Abbey.Garber@tklaw.com

Crawford Moorefield
Term expires 2022
Spencer Fane
3040 Post Oak Blvd, Ste. 1300
Houston, Texas 77056
(713) 214-2645
cmoorefield@spencerfane.com

Leonora ("Lee") S. Meyercord
Term expires 2023
Thompson & Knight LLP
1722 Routh Street, Suite 1500
Dallas, Texas 75201
(214) 969-1315
Lee.Meyercord@tklaw.com

Mike A. Villa
Term expires 2023
Meadows, Collier, Reed, Cousins, Crouch & Ungerman, LLP
901 Main Street, Suite 3700
Dallas, Texas 75202
(214) 749-2405
mvilla@meadowscollier.com

Carol Warley
Term expires 2023
RSM US LLP
1330 Post Oak Blvd., Suite 2400
Houston, Texas 77056
(713) 625-3583
carol.warley@rsmus.com

Ex Officio Council Members

Christi Mondrik
Immediate Past Chair
Mondrik & Associates
11044 Research Blvd., Suite B-400
Austin, Texas 78759
(512) 542-9300
cmondrik@mondriklaw.com

Professor Bruce McGovern
Law School Representative
Professor of Law
South Texas College of Law
1303 San Jacinto
Houston, Texas 77002
(713) 646-2920
bmcgovern@stcl.edu

Audrey Morris
IRS Liaison
Internal Revenue Service
MC 2000 NDAL
13th Floor
4050 Alpha Road
Dallas, Texas 75244
(469) 801-1112
audrey.m.morris@irscounsel.treas.gov

Alyson Outenreath
Law School Representative
Professor of Law
Texas Tech University School of Law
1802 Hartford,
Lubbock, Texas 79409
(806) 834-8690
alyson.outenreath@ttu.edu

Bree Boyett
Tax Litigation Attorney
Texas Comptroller of Public Accounts
1700 N. Congress Avenue, Suite 320
Austin, Texas 78701
(512) 463-3627
bree.boyett@cpa.texas.gov

TAX SECTION
THE STATE BAR OF TEXAS
COMMITTEE CHAIRS AND VICE CHAIRS
2020-2021

	COMMITTEE	CHAIR	VICE CHAIR
1.	**Annual Meeting**	**Laurel Stephenson** Davis Stephenson, PLLC 100 Crescent Ct., Suite. 440 Dallas, Texas 75201 *(214) 396-8802* laurel@davisstephenson.com **John Strohmeyer** Strohmeyer Law PLLC 2925 Richmond Avenue 12th Floor Houston, Texas 77098 *(713) 714-1249* john@strohmeyerlaw.com	**Mr. William David Elliott** Elliott, Thomason & Gibson, LLP 2626 Cole Ave, Suite 600 Dallas, Texas 75204-1053 *(214) 922-9393* bill@etglawfirm.com
2.	**Continuing Legal Education**	**Abbey B. Garber** Thompson & Knight 1722 Routh Street, Suite 1500 Dallas, Texas 75201 *(214) 969-1640* Abbey.Garber@tklaw.com **Michael Threet** Haynes and Boone, LLP 2323 Victory Avenue, Suite 700 Dallas, Texas 75219 *(214) 651-5091* michael.threet@haynesboone.com **Amanda Traphagan** Seay & Traphagan, PLLC 807 Brazos St., Suite 304 Austin, Texas 78701 *(512) 582-0120* atraphagan@seaytaxlaw.com	

	COMMITTEE	CHAIR	VICE CHAIR
3.	**Corporate Tax**	**Kelly Rubin** Jones Day 2727 North Harwood Street Dallas, Texas 75201-1515 *(214) 969-3768* krubin@jonesday.com	**Jim Dossey** Dossey & Jones 25025 I-45 #575 The Woodlands, Texas 77380 *(281) 410-2792* jim@dossey.com
4.	**Employee Benefits**	**Misty Leon** Wilkins Finston Law Group LLP Galleria Tower III 13155 Noel Road, Suite 900 Dallas, Texas 75240 *(972) 359-0087* MLeon@wifilawgroup.com	**Jessica S. Morrison** Thompson & Knight LLP 777 Main Street, Suite 3300 Fort Worth, Texas 76102 *(817) 347-1704* Jessica.Morrison@tklaw.com
5.	**Energy and Natural Resources Tax**	**Crawford Moorefield** Spencer Fane 3040 Post Oak Blvd, Ste. 1300 Houston, Texas 77056 *(713) 214-2645* cmoorefield@spencerfane.com **Hersh Verma** Norton Rose Fulbright US LLP 1301 McKinney, Suite 5100 Houston, Texas 77010 *(713) 651-5164* hersh.verma@nortonrosefulbright.com	
6.	**Estate and Gift Tax**	**Carol Warley** RSM US LLP 1330 Post Oak Blvd., Suite 2400 Houston, Texas 77056 *(713) 625-3583* carol.warley@rsmus.com	**Sarah Marks** Thompson & Knight 1722 Routh Street, Suite 1500 Dallas, Texas 75201 *(214) 969.1228* sarah.marks@tklaw.com **Carolyn Starr** Fizer Beck 5718 Westheimer, Suite 1750 Houston, Texas 77057 *(713) 840-7710* cstarr@fizerbeck.com

COMMITTEE		CHAIR	VICE CHAIR
7.	**General Tax Issues**	**Prof. Bruce McGovern** South Texas College of Law 1303 San Jacinto Houston, Texas 77002 *(713) 646-2920* bmcgovern@stcl.edu	**Dustin Whittenburg** Law Office of Dustin Whittenburg 4040 Broadway, Suite 450 San Antonio, Texas 78209 *(210) 826-1900* dustin@whittenburgtax.com
8.	**Government Submissions (COGS)**	**Sam Megally** K&L Gates, LLP 1717 Main Street, Suite 2800 Dallas, Texas 75201 *(214) 939-5491* sam.megally@klgates.com	**Jason Freeman** Freeman Law, PLLC 2595 Dallas Parkway, Suite 420 Frisco, Texas 75034 *(214) 984-3410* Jason@freemanlaw-pllc.com **Josh Prywes** Greenberg Traurig, LLP 2200 Ross Avenue, Suite 5200 Dallas, Texas 75201 *(214) 665-3626* prywesj@gtlaw.com
9.	**International Tax**	**John R. Strohmeyer** Strohmeyer Law PLLC 2925 Richmond Ave., 12th Floor Houston, Texas 77098 *(713) 714-1249* john@strohmeyerlaw.com	**Ryan Dean** Freeman Law, PLLC 2595 Dallas Parkway, Suite 420 Frisco, Texas 75034 *(214) 308-2864* rdean@freemanlaw-pllc.com **Kevin T. Keen** Withers Bergman LLP 700 Milam Street, Suite 1300 Houston, TX 77002 281 640 4241 713 583 6537 (fax) Kevin.Keen@withersworldwide.com **John Woodruff** Polsinelli PC 1000 Louisiana Street Suite 6400 Houston, Texas 77002 *(713) 374-1651* jwoodruff@polsinelli.com

COMMITTEE		CHAIR	VICE CHAIR
10.	**Law School Outreach**	**Audrey Morris** Internal Revenue Service MC 2000 NDAL 13th Floor 4050 Alpha Road Dallas, Texas 75244 *(469) 801-1112* audrey.m.morris@irscounsel.treas.gov **Prof. Alyson Outenreath** Professor of Law Texas Tech University School of Law 1802 Hartford, Lubbock, Texas 79409 *806-834-8690* alyson.outenreath@ttu.edu	
11.	**Leadership Academy**	**Robert C. Morris** Norton Rose Fulbright US LLP 1301 McKinney, Suite 5100 Houston, Texas 77010 *(713) 651-8404* robert.morris@nortonrosefulbright.com	
12.	**Newsletter**	**Aaron Borden** Grant Thornton 1717 Main Street, Suite 1800 Dallas, Texas 75201 *(214) 561-2604* Aaron.Borden@us.gt.com	

COMMITTEE		CHAIR	VICE CHAIR
13.	**Partnership and Real Estate**	**Leonora ("Lee") S. Meyercord** Thompson & Knight LLP 1722 Routh Street, Suite 1500 Dallas, Texas 75201 *(214) 969-1315* Lee.Meyercord@tklaw.com **Nathan ("Nate") Smithson** Jackson Walker LLP 2323 Ross Avenue, Suite 600 Dallas, Texas 75201 *(214) 953-5641* nsmithson@jw.com	**Preston ("Trip") Dyer** Winstead PC 2728 N. Harwood St., Suite 500 Dallas, Texas 75201 *(214) 745-5297* pdyer@winstead.com **Argyrios ("Argy") C. Saccopoulous** Jackson Walker LLP 100 Congress Ave., Suite 1100 Austin, Texas 78701 *(512) 236-2062* asaccopoulos@jw.com
14.	**Pro Bono**	**Robert D. Probasco** Texas A&M University School of Law 307 W. 7th Street, Suite LL50 Fort Worth, Texas 76102 *214-335-7549* probasco@law.tamu.edu **Rachael Rubenstein** Clark Hill Strasburger, LLP 2301 Broadway Street San Antonio, Texas 78215 *(210) 250-6006* rachael.rubenstein@clarkhillstrasburger.com	**Tiffany Hamil** Law Office of Tiffany Hamil 6220 Campbell Rd., Suite 203 Dallas, Texas 75248 *(214) 369-0909* dfwtaxadvisor@gmail.com **Jaime Vasquez** Chamberlain, Hrdlicka, White, Williams, & Aughtry, PC 112 East Pecan Street, St 1450 San Antonio, Texas 78205 *(210) 507-6508* jaime.vasquez@chamberlainlaw.com
15.	**Property Tax**	**Daniel Richard Smith** Popp Hutcheson PLLC 1301 S Mo PAC Expy Suite 430 Austin, Texas 78746 *(512) 664-7625* Daniel.smith@property-tax.com	**Ryan James** Low Swinney Evans & James, PLLC 3305 Northland, Ste. 500 Austin, Texas 78731 *(512) 379-5800* rjames@lsejlaw.com **Tracy Turner** Brusniack Turner Fine, LLP 17480 Dallas Pkwy, Ste 210 Dallas, Texas 75370 *(214) 295-6095* tracy@texaspropertytaxattorneys.com

	COMMITTEE	CHAIR	VICE CHAIR
16.	**Solo and Small Firm**	**Irina Barahona** Attorney at Law 10420 Montwood Dr., Ste. N. 125 El Paso, Texas 79935 *(915) 228-4905* ibarahona@izblaw.com **Sara Giddings** 1309 N, Avenue E Shiner, Texas 77984 *(903) 436-2536* sara@trentnicholslaw.com	**Christopher James** James Management Group 4261 East University Drive, Suite 303-503 Prosper, Texas 75078 *(214) 901-8140* cjames@jmgglobal.com
17.	**Sponsorship**	**Crawford Moorefield** Spencer Fane 3040 Post Oak Blvd, Ste. 1300 Houston, Texas 77056 *(713) 214-2645* cmoorefield@spencerfane.com	
18.	**State and Local Tax**	**Matt Hunsaker** BakerHostetler 3838 Oak Lawn Avenue | Suite 1150 Dallas, Texas 75219 *(214) 210-1214* mhunsaker@bakerlaw.com **Stephen Long** Baker & McKenzie LLP 2001 Ross Ave., Suite 2300 Dallas, Texas 75201 *(214) 978-3086* stephen.long@bakermckenzie.com	**Will LeDoux** K&L Gates, LLP 1717 Main Street, Suite 2800 Dallas, Texas 75201 *(214) 939-4908* william.ledoux@klgates.com **Julio Mendoza-Quiroz** Texas Comptroller of Public Accounts 1700 N. Congress, Suite 200 Austin, Texas 78701 *(512) 475-5637* Julio.Mendoza-Quiroz@cpa.texas.gov **Robin Robinson** Deloitte Tax LLP 500 West 2nd St., Ste. 1600 Austin, Texas 78701 *(512) 226-4628* rorobinson@deloitte.com

	COMMITTEE	CHAIR	VICE CHAIR
19.	**Tax Controversy**	**Juan Vasquez** Chamberlain, Hrdlicka, White, Williams, & Aughtry, PC 1200 Smith Street, Suite 1400 Houston, Texas 77002 *713-658-1818* juan.vasquez@chamberlainlaw.com **Mike A. Villa** Meadows, Collier, Reed, Cousins, Crouch & Ungerman, LLP 901 Main Street, Suite 3700 Dallas, Texas 75202 *(214) 749-2405* mvilla@meadowscollier.com	**Bucky Brannen** Baker Botts LLP 2001 Ross Avenue Dallas, Texas 75201-2980 *(214) 953-6619* bucky.brannen@bakerbotts.com **Jimmy Martens** Martens, Todd, Leonard & Ahlrich 816 Congress Avenue, Suite 1500 Austin, Texas 78701 jmartens@textaxlaw.com
20.	**Tax Law in a Day**	**Renesha Fountain** Chamberlain, Hrdlicka, White, Williams, & Aughtry, PC 1200 Smith Street, Suite 1400 Houston, Texas 77002 *(713) 658-2517* renesha.fountain@chamberlainlaw.com	**Harriet Wessel** Mondrik & Associates 11044 Research Blvd., Ste. B-400 Austin, Texas 78759 *(512) 542-9300* hwessel@mondriklaw.com
21.	**Tax-Exempt Finance**	**Adam Harden** 300 Convent St, Suite 2100 San Antonio, Texas 78205 *(210) 270-7120* adam.harden@nortonrosefulbright.com **Peter D. Smith** Norton Rose Fulbright 98 San Jacinto Blvd., Suite 1100 Austin, Texas 78701 *(512) 536-3090* peter.smith@nortonrosefulbright.com	
22.	**Tax-Exempt Organizations**	**Katherine ('Katy") David** Clark Hill Strasburger, LLP 2301 Broadway Street San Antonio, Texas 78215 *(210) 250-6122* katy.david@clarkhillstrasburger.com	**Megan Sanders** Bourland, Wall & Wenzel, P.C. 301 Commerce, Suite 1500 Fort Worth, Texas 76102 *(817) 877-1088* msanders@bwwlaw.com