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CHAIR'S MESSAGE

As my term as your Chair draws to a close, I am very excited about what we have accomplished. The following is an update of our significant projects:

1. Annual Meeting. The Tax Section's Annual Meeting will be held in Dallas on June 24, 2005 at the Wyndham Anatole Hotel at 10:30 a.m. We expect to address two main matters. First, pursuant to our new Bylaw procedures, the Nominating Committee recommends the following new officers and Council members and the Council has duly approved these nominations:

Officers		Council Members (term expiring in 2008)
Chair Elect	Gene Wolf	Dan Baucum
Secretary	Kevin Thomason	Tina Green
Treasurer	Allen Craig	Mary McNulty

Pursuant to our Bylaws, Bill Bowers will automatically become Chair of the Tax Section.

2. New Committees. Our second order of business will be to amend our Bylaws to add two new committees. First, we will add a Pro Bono Committee. Serving the community is an important and worthwhile goal of any bar association. In order to give this subject the attention it deserves, we are implementing a standing committee on pro bono activities. Initially the Pro Bono Committee will focus its efforts on three areas: (i) participate in a pilot project with VITA in Dallas; (ii) work through Texas C-Bar; and (iii) handle general non-tax related pro bono projects. Dan Micciche has been very active in helping create this new committee.

The second new committee will be the Committee on Government Submissions ("COGS"). This is an exciting new committee which will review and approve comments on proposed Treasury regulations. The members of the committee will be appointed by the Chair of the Tax Section. Typically, the committee would consist of current Tax Section officers, certain past Chairs of the Section and other Section members with significant experience in tax matters.

A proposed regulation comment project will be submitted in writing to COGS by the committee chair responsible for the substantive area involved. Any Tax Section member may approach the committee chair regarding the regulation project, but the committee chair will act as a filter and only bring projects to COGS that such committee chair deems worthy of consideration.

The first step in the comment process will be that COGS must approve the regulation comment project in concept. The second step, after the comments have been drafted, is COGS' review and approval of the comments before they are submitted to the government. The third step is the review of the comments by the Chair of the Section and their submission to the government.

3. New Seminars. This year we are having two new seminars. The first headed by Kevin Thomason, Dan Baucum and Dan Micciche was on April 22nd entitled "The American Jobs Creation Act of 2004 and Circular 230." This seminar included Eric Solomon and Helen Hubbard with the Treasury Department, as well as several experienced Texas tax practitioners. This program was a joint effort between the State Bar of Texas and the Tax Section. A unique feature is that the seminar was carried on the internet via webcast.

The second new seminar will be a one-hour presentation on recent Texas tax developments at the Annual Meeting. Again, this will be a joint effort between the Tax Section and the State Bar. Dan Micciche will be leading this presentation and it is also expected to be webcast.

4. Website. Our Website Chair, Patrick O'Daniel, continues to improve the Tax Section's website. Of particular interest is that Patrick is rapidly adding CLE outlines from various Tax Section seminars to the website. To access these outlines, simply go to www.texastaxsection.org and you will see three columns. In the left column, click on "Members Only" and you will type in your bar card number and password. It will take you to another page with a 3-column format. On the lower left side, there is a Google search engine and other headings for "Texas Tax Lawyer Archives", "Outlines" and "Tax Section Manual".

As we prepare for the Annual Meeting which will officially close out my term as Chair, I look back fondly on the opportunity to serve you over the years in Tax Section matters. The Tax Section continues to be a dynamic and worthwhile organization. It has been particularly enjoyable to work with the fine people that are involved in our Section. Thank you for giving me the opportunity to do so.

R. David Wheat

EDITOR'S MESSAGE

This is the last edition of the *Texas Tax Lawyer* for which I will serve as its Editor. It has been my honor to serve the Tax Section in this capacity, and I thank the Section leadership for this opportunity. I have had the privilege of working with many tax practitioners from all over the state who represent some of the premier experts in our area. Without their input, there would be no newsletter to publish. I would like to take this time to thank all of you who have authored current development reports or articles for publication. In addition, I would like to thank my assistant, Diana Roth, for all of her hard work in each newsletter we have sent to publication.

There is still much work to be done. I know that Michelle Kwon will serve the Section well as the new Editor of the *Texas Tax Lawyer* and bring a fresh perspective to the job. Of the many things that I have learned in this position over the last three years, the most important is to get involved – join a committee, write an article for publication, attend the annual meeting, etc. The more you put into the Section, the more you will benefit from it. Thank you again for the opportunity to serve as your Editor.

Tina R. Green

VERIFY YOUR COMMITTEE MEMBERSHIPS

BY REVIEWING THE COMMITTEE ROSTERS BEGINNING ON PAGE 41.

If you believe you are a member of a committee and your name is not listed, or if you want to join a committee, please complete the Committee Selection Form at the back of the newsletter and forward it to the Chairman of the committee you wish to join. Conversely, if you are listed as being on a committee and you do not want to be a member of that committee, please contact the Chairman to have your name removed from the Committee Roster.

NOTICE OF ANNUAL MEETING

The Council Members and Officers

of the State Bar of Texas Tax Section

cordially invite

the Members of the Tax Section

to attend the Section's Annual Meeting

to be held at the

Wyndham Anatole
2201 Stemmons Freeway
Dallas, Texas 75207
(214) 748-1200

on

Friday, June 24, 2005 from 10:00 a.m. to 11:30 a.m.

with lunch to follow at 12:00 noon.

Agenda items will include the Members' election of
officers and three council members

OUTSTANDING TEXAS TAX LAWYER AWARD

The Council of the Section of Taxation will be awarding for 2005 the annual "Outstanding Texas Tax Lawyer" award. To be qualified, a nominee must: be a member in good standing of the State Bar of Texas or an inactive member thereof; have been licensed to practice law in Texas or another jurisdiction for at least ten years; and have devoted at least 75 percent of his or her law practice to taxation law. "Law practice" means work performed primarily for the purpose of rendering legal advice or providing legal representation, and also includes: service as a judge of any court of record; corporate or government service if the work performed was legal in nature and primarily for the purpose of providing legal advice to, or legal representation of, the corporation or government agency or individuals connected therewith; and the activity of teaching at an accredited law school; and "Taxation law" means "Tax Law" as defined by the Texas Board of Legal Specialization's standards for attorney certification in Tax Law; tax controversy; employee benefits and executive compensation practice; criminal defense or prosecution relating to taxation; taxation practice in the public and private sectors, including the nonprofit section; and teaching taxation law or related subjects at an accredited law school. In selecting a winner, the Council will consider a nominee's reputation for expertise and professionalism within the community of tax professionals specifically and the broader legal community; authorship of scholarly works relating to taxation law; significant participation in the State Bar of Texas, American Bar Association, local bar associations, or legal fraternities or organizations; significant contributions to the general welfare of the community; significant pro bono activities; reputation for ethics; mentorship of other tax professionals; experience on the bench relating to taxation law; experience in academia relating to taxation law; and other significant contributions or experience relating to taxation law.

The award will be made at the 2005 Advanced Tax Law course in September, so any nominations should be submitted on the following form to Bill Bowers, either by email (bbowers@fulbright.com) or hardcopy (fax number 214-855-8200) no later than June 30, 2005.

NOMINATION FOR OUTSTANDING TEXAS TAX LAWYER AWARD

Nominee Name: ____

Mailing Address: ____

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

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SECTION OF TAXATION OF THE STATE BAR OF TEXAS

2004-2005 CALENDAR

July	
9	New Chair/Treasurer Orientation, Texas Law Center – Austin
15	Quarterly dues check mailed to Section Treasurers
30-31	SBOT Bar Leaders Conference, Omni Mandalay, Las Colinas
August	
10	Texas Bar Foundation grant application deadline
13	Deadline for submitting articles for the October 2004 issue of the Texas Tax Lawyer
September	
1	Inform State Bar of Section's Annual Meeting program chair
10	Council of Chairs meeting, TLC, Room 101, Austin
24	10:30 a.m. – 12:30 p.m. Council/Committee Chairs Meeting **MANDATORY IN PERSON ATTENDANCE BY ALL COUNCIL MEMBERS AND EITHER CHAIR OR VICE CHAIR** Thompson & Knight LLP 1700 Pacific Avenue, Suite 3300 Dallas, Texas 75201 (214) 969-1468
October	
4	SBOT section program chair: Select program and proposed speakers for SBOT Annual Meeting 2005
15	Quarterly dues check mailed to Section Treasurer
21	State Bar of Texas CLE 22nd Advanced Tax Law Course (co-sponsored by the Section of Taxation) in Dallas, Texas. For more information, visit www.TexasBarCLE.Com click on "Courses" and search Practice Areas for "Tax"
29-30	National Association of State Bar Tax Sections Annual Conference. San Francisco, California

November	
19	10:30 A.M. – 12:30 P.M. Council/Committee Chairs Meeting Thompson & Knight LLP 1700 Pacific Avenue, Suite 3300 Dallas, Texas 75201 (214) 969-1468
December	
10	Deadline for submitting articles for the February 2005 issue of the Texas Tax Lawyer
12	Prepare section mid-year report (due Jan. 1)
January	
15	Quarterly dues check mailed to Section Treasurer
21	Council of Chairs Meeting, Austin
28	10:30 a.m. – 12:30 p.m. Council/Committee Chairs Meeting **MANDATORY IN PERSON ATTENDANCE BY ALL COUNCIL MEMBERS AND EITHER CHAIR OR VICE CHAIR** Thompson & Knight LLP 1700 Pacific Avenue, Suite 3300 Dallas, Texas 75201 (214) 969-1468
20-22	ABA Section of Taxation Midyear Meeting, San Diego, CA
February	
4	Send information to State Bar for promotional Section flyers and Annual Meeting registration form
March	
4	10:30 a.m.- 12:00 p.m. Council/Committee Chairs Meeting Thompson & Knight LLP 1700 Pacific Avenue, Suite 3300 Dallas, Texas 75201 (214) 969-1468
11	Deadline for submitting articles for the May 2005 issue of the Texas Tax Lawyer
TBD	Property Tax Committee Annual Seminar, Austin, Texas

April	
1	Deadline for SBOT Annual Meeting resolutions
1	Council of Chairs Meets – TLC, Austin
15	Quarterly dues check mailed to section treasurer
15	Prepare section end-of-the year report for publication in July Bar Journal
May	
19-21	ABA Section of Taxation May Meeting, Washington, D.C.
13	10:30 a.m. – 12:30 p.m. Council/Committee Chairs Meeting Thompson & Knight LLP 1700 Pacific Avenue, Suite 3300 Dallas, Texas 75201 (214) 969-1468
June	
9-10	Texas Federal Tax Institute
23-25	SBOT Annual Meeting, Dallas

Mark your Calendar!!

The 23nd Annual Advanced Tax Law Course

including
the latest information on recent legislative changes and
case law developments

September 29 and 30, 2005
Wyndham Dallas Market Center
2015 Market Center Boulevard
Dallas, Texas 75207
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The Taxation Section of the State Bar of Texas
and Texas Bar CLE

Call the State Bar of Texas for more information
800-204-2222, ext. 1574
(in Austin) 512-463-1463, ext. 1574

Mark Your Calendar!

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FOR FEDERAL AND STATE TAX MATTERS

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a live webcast
and
the latest tips on successfully litigating a tax case

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800-204-2222, ext. 2045
(in Austin) 512-463-1463, ext. 2045

ENERGY AND NATURAL RESOURCES TAX: RECENT DEVELOPMENTS

by Mary A. McNulty[1]

The following is a summary of selected current developments in the law relating to the energy and natural resources tax area. The summary focuses on federal tax law. It has been prepared by Mary A. McNulty, Chair of the Energy and Natural Resources Committee and a partner at Thompson & Knight LLP, and Alyson Outenreath,[2] an associate at Thompson & Knight, as a project of the Energy and Natural Resources Tax Committee. Unless otherwise indicated, all Section references are to the Internal Revenue Code of 1986, as amended (the "Code").

A. Guidance Issued on New Domestic Production Deduction

The American Jobs Creation Act of 2004 (P.L. 108-357) added a deduction for income attributable to domestic production activities. The deduction generally equals three percent of income from domestic production activities for 2005 and, by 2010, nine percent of such income. Some activities eligible for the deduction include the manufacture of natural gas or water and the production of electricity.

The Internal Revenue Service (the "Service") issued interim guidance concerning the deduction in Notice 2005-14, 2005-7 I.R.B. 498 (Feb. 14, 2005). The Notice provides detailed guidance on all aspects of the manufacturing deduction. The Notice further provides that the Service and the Treasury Department currently are developing Treasury regulations under Section 199 regarding the deduction. Notice 2005-14 is intended to provide interim guidance on which taxpayers may rely until the Treasury regulations are issued. The Service has indicated that it expects the regulations to incorporate the rules set forth in the Notice and will be effective for taxable years beginning after December 31, 2004, which is the effective date of Section 199.

In a webcast held on January 26, 2005, sponsored by Ernst & Young, Treasury Tax Legislative Counsel, Helen Hubbard, fielded questions and encouraged comments about the new domestic production deduction. Hubbard indicated that Section 3 of Notice 2005-14 is intended to provide an explanation of the deduction, similar to a preamble, and Section 4 is intended to provide the operative rules. As to natural resource operations, Hubbard stated that it was possible for a taxpayer to be treated as a producer for Section 263A purposes, but not for Section 199.

B. Guidance Issued on Excise Tax Provisions

The Service issued guidance in Notice 2005-4, 2005-2 I.R.B. 289 (Jan. 10, 2005) on the excise tax provisions introduced and/or amended by the American Jobs Creation Act of 2004 (P.L. 108-357). The Notice clarifies the excise treatment as to alcohol and biodiesel fuels, off-highway vehicles, aviation-grade kerosene, diesel fuel used in some buses, registration displays on some vessels, gasoline sales to state and local governments and nonprofit educational organizations, two-party taxable fuel exchanges, and transmix and diesel fuel blendstock classifications.

The Notice is the subject of a notice of proposed rulemaking ("NPRM") that the Treasury and the Service plan to issue in 2005. The Notice indicates that excise tax provisions on which guidance was not provided may be the subject of future guidance or addressed in the NPRM.

Several organizations submitted comments in response to Notice 2005-4, including the American Petroleum Institute, the Minnesota Soybean Growers Association, and the Petroleum Marketers Association of America. The comments related to such items as (i) suggesting which diesel fuel blendstocks should be classified as diesel fuel, (ii) incorporating certain provisions into the regulations relating to transmix used for non-highway purposes, (iii) requesting more detailed guidance on the party allowed to the take the credit in two-party exchanges, (iv) clarifying the meaning of the term "blender" as applicable to blends of alcohol and biodiesel fuel under Sections 6426 and 6427, and (v) requesting additional guidance relating to several issues pertaining to biodiesel fuel.

C. Upgraded Hydrocarbons are Oil From Tar Sands for Purposes of Percentage Depletion Limitations

The Service issued PLR 200503003 (Jan. 21, 2005), which involved classifying certain upgraded hydrocarbons for purposes of the percentage depletion limitations that apply to oil and gas wells.

The taxpayer requested the following rulings:

1. The hydrocarbon recovered from the Y formation through open pit mining is oil from tar sands, and not crude oil, for purposes of Sections 613A and 291(b);

2. The hydrocarbon recovered from the X lease, through use of the Process is oil from tar sands, and not crude oil, for purposes of Sections 613A and 291(b);

3. Refining tar sand oil is not the refining of crude oil under Section 613A(d)(4);

4. The volume of tar sand oil processed in a upgrader or refinery is disregarded under the 50,000 barrel per day crude oil exclusion under Section 613A(d)(4); and

5. The refining of tar sand oil by the taxpayer's proposed joint venture is not relevant to the determination of whether it is an integrated oil company under Section 291(b).

The Service indicated that it is well established that tar sand oil and crude oil are mutually exclusive categories of hydrocarbons. Therefore, the Service concluded with respect to the taxpayer's third ruling request, the refining or upgrading of oil from tar sands is not the refining of crude oil. As to the taxpayer's fourth ruling request, the Service concluded that, for purposes of Section 613A(d)(4), the upgrading or refining of tar sand oil is not considered in determining whether a taxpayer's refining exceeds 50,000 barrels of crude oil per day. As to the taxpayer's fifth ruling request, the Service concluded that the taxpayer's upgrading of tar sand oil had no impact on whether the taxpayer will be considered an integrated oil company under Section 291(b)(4), relating to intangible drilling costs as corporate preference items, due to the application of Section 613A(d)(4).

Because the taxpayer represented that the hydrocarbon produced through surface mining is immobile, the Service concluded that the hydrocarbon recovered through open pit mining and then upgraded is tar sand oil within the meaning of FEA Ruling 1976-4. The Service noted that open pit mining was not a conventional well production method used in 1980. Accordingly, the Service concluded, as to the taxpayer's first ruling request, that the upgraded hydrocarbons removed from the Y formation through open pit mining is oil from tar sands, and not crude oil, for purposes of Sections 613A and 291(b).

With respect to the X lease, the Service focused on the fact that the hydrocarbon would be immobile under reservoir conditions. The Service also considered the density of the hydrocarbons and other related characteristics. The Service noted that no primary production from the X lease had been attempted and that the process was not a conventional well production method or enhanced recovery technique used in 1980. The Service concluded that the taxpayer had shown that the hydrocarbon would be tar sand oil within the meaning of FEA Ruling 1976-4. Accordingly, the Service concluded, as to the taxpayer's second ruling request, that the upgraded hydrocarbon recovered from the X lease through use of the process would be oil from tar sands, and not crude oil, for purposes of Sections 613A and 291(b).

D. <u>Fuel Tax Registration Requirements Must Be Satisfied by Facility Owner</u>

The Service issued TAM 200508014 (Feb. 25, 2005), which involved the issue of whether an owner-operator of a fuel transport facility must register under Section 4101(a).

Section 4101(a) provides that every person required by the Secretary to register with respect to the tax imposed by Section 4081 shall register in the time and manner required by the Treasury regulations. Section 48.4101-1(c)(1) of the Treasury regulations provides that refiners are required to register under Section 4101. Section 48.4081-1(b) of the Treasury regulations defines the term "refiner" as any person that owns, operates, or otherwise controls a refinery. The term "refinery" is defined as a facility used to produce taxable fuel and from which taxable fuel may be removed by pipeline, by vessel, or at a rack. But the term does not include a facility where only blended fuel or gasohol and no other type of taxable fuel is produced.

The facts present in TAM 200408014 involved X, which owns and operates a facility that includes a fuel transport loading and unloading rack, pipelines, a distillation unit, and storage tanks. X purchases transmix that contains gasoline. The transmix consists of varying proportions of gasoline, diesel fuel, and other hydrocarbon products that are mixed during transport in the pipeline. The transmix is delivered to X's facility via common carrier and then unloaded at an unloading rack connected by pipeline to the transmix storage tank. The transmix is fed from the storage tank to the distillation unit by a pipeline. The distillation unit refines the transmix by separating hydrocarbons into gasoline and diesel fuel, which are then transferred to separate storage tanks. The gasoline and diesel fuel are them removed from their storage tanks at the rack for delivery to the retail market via tank trucks.

The Service concluded that the distillation unit is a facility that produces taxable fuel (gasoline and diesel fuel) from transmix that is stored in tanks and removed at the rack. Therefore, the Service concluded that the distillation unit is a refinery within the meaning of Section 48.4081-1(b) of the Treasury regulations. Accordingly, X, as owner of the refinery, is a refiner and required to register pursuant to Section 4101(a).

E. U.S. Supreme Court Grants Certiorari in Case Concerning Fuel Tax

The U.S. Supreme Court granted certiorari in the Tenth Circuit case of *Prairie Band Potawatomi Nation v. Richards*, No. 379 F.3d 979 (10th Cir. 2004), S. Ct. Dkt. No. 04-631 (Feb. 28, 2005). The case involves a Kansas tax on motor fuel and how the tax applies to entities that do business with Indian tribes. In the case, the Tenth Circuit held that the interest-balancing test of *White Mountain Apache Tribe v. Bracker* preempts a nondiscriminatory Kansas tax imposed off reservation on nontribal entities that do business with Indian tribes and pass the tax costs on to the tribes. This decision will be one of several other decisions dealing with taxation issues relating to entities that do business with Indian tribes.

F. Coalition Formed to Seek Extension of Production Tax Credit for Renewable Energy

On December 20, 2004, leading renewable energy business organizations announced the formation of the Renewable Energy Business Alliance. The alliance was formed to unify support of policies and programs to expand renewable energy production in the United States. The alliance is made up of trade associations representing the wind, solar, geothermal, biomass, landfill gas, and waste-to-energy industries, as well as public power and rural electric cooperatives. As a priority, the alliance will seek a significant extension of the production tax credit for renewable energy under Section 45, which under current law, generally is available for a ten year period beginning on the placed in service date of the qualifying facility (five year availability for certain facilities).

G. Section 29 Credits

The IRS issued additional guidance on common issues, including : (1) whether fuel constitutes a qualified fuel within the meaning of Section 29(c)(1)(C); (2) whether production of qualified fuel from a facility will be attributable solely to the taxpayer within the meaning of Section 29(a)(2)(B), entitling the taxpayer to the Section 29 credit for qualified fuel from the facility that is sold to an unrelated person; (3) whether the Section 29 credit may be allocated to partners of the taxpayer in accordance with the partners' interests in the taxpayer when the credit arises; (4) whether relocation of a facility to a different location after June 30, 1998, or the replacement of part of any facility after that date, will result in a new placed in service date for the facility for purposes of the Section

29 credit; and (5) whether a termination of the taxpayer under Section 708(b)(1)(B) will preclude the reconstituted partnership from claiming the Section 29 credit on the production and sale of synthetic fuel to unrelated persons.

See PLR 200501009 (Jan. 7, 2005), PLR 200502022 (Jan. 14, 2005), PLR 200502023 (Jan. 14, 2005).

ENDNOTES

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2 Thompson & Knight LLP, 1700 Pacific Avenue, Suite 3300, Dallas, Texas 75201, (214) 969-1741, (214) 880-3276 (fax), alyson.outenreath@tklaw.com.

PARTNERSHIP AND REAL ESTATE TAX: RECENT DEVELOPMENTS

by Michael Threet [1]

The following is a summary of selected current developments in the law applicable to partnership and real estate tax matters. Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code") and all references to the Internal Revenue Service are abbreviated as "IRS".

A. PARTNERSHIP TAXATION

1. Transferors Of Patent Contributed To LLC Remained "Holder" Under Code Section 1235.

Generally, under Code section 1235, the transfer of all substantial rights to a patent by a "holder" to an unrelated individual is treated as the sale or exchange of a capital asset held for more than one year. A "holder" of a patent is generally the individual inventor or certain individuals who purchased their interests in the patent from the inventor. Although a partnership cannot be a holder, each member of a partnership who is an individual may be a holder as to his share of the patent owned by the partnership. Long-term treatment under Code section 1235 applies regardless of the actual time the patent is held or whether the payments might otherwise be treated as royalties.

In three related Private Letter Rulings, the IRS addressed the situation of three individual inventors who together developed a product for which they obtained patents as co-inventors and joint owners. Each of the inventors transferred their respective interests in the product, including their interest in the patents, trade secrets, know-how, and other intellectual property associated with the product, to an LLC wholly owned by them. The rulings concluded that because the LLC formed by the inventors will be classified as a partnership for federal income tax purposes, each member will be treated as a partner and holder for purposes of Code section 1235 following the transfer of their interests to the LLC. As holders, each inventor's share of any gain recognized by the LLC upon its disposition of an interest in the patents will qualify as long-term capital gain if the requirements of Code section 1235 are otherwise met. PLR 200506008 (February 11, 2005); PLR 200506009 (February 11, 2005); PLR 200506019 (February 11, 2005).

2. Chief Counsel Confirms Position That the Internal Revenue Service Can Levy On General Partners' Property To Collect Partnership's Employment Tax Liability.

In a Chief Counsel Notice, the IRS confirmed its position that an assessment of employment tax liability against a partnership permits it to collect those taxes administratively by lien or levy from the general partners of the partnership and that the Supreme Court's decision in *United States v. Galletti*, 541 U.S. 114 (2004), did not alter this position. In *Galletti*, the Supreme Court ruled that a timely assessment of a partnership's employment tax liability extends the limitations period on collection against both the partnership and the general partners, who are liable for partnership debts under state law. However, because the case involved the IRS' collection efforts against the partners in a *judicial proceeding*, the Supreme Court did not address whether the assessment against a partnership was sufficient to extend the period for the IRS to commence *administrative* collection action against a general partner's property by lien or levy.

The IRS has a long-established legal position that it has can enforce a tax lien and levy against general partners' property based on an assessment directed to the partnership. Accordingly, notice and demand to the partnership gives rise to a tax lien on both the property of the partnership and the property of the general partners. CC-2005-003, (January 19, 2005).

3. IRS Provides Guidance on the Tax Treatment of Partnership HSA Contributions.

The IRS has provided new guidance in question and answer format that clarifies the treatment of a partnership's contributions to a partner's health savings account (HSA). The Notice clarifies that, in general, contributions by a partnership to a partner's HSA are not treated as contributions by an employer to an employee's HSA, but are generally treated as payments to the partner and are includible in gross income.

Contributions by a partnership to a partner's HSA that are treated as a distribution to the partner are not deductible by the partnership and do not affect the distributive shares of partnership income and deductions. In addition, these deemed distributions are not included in the partner's self-employment income net earnings (because Code section 731 distributions do not affect a partner's Code section 702(a)(8) distributive share of partnership income or loss) and the individual partner may claim an above-the-line deduction for the contribution in accordance with Code section 223.

However, contributions by a partnership to a partner's HSA for services rendered to the partnership that are treated as guaranteed payments may generally be deducted as a business expense by the partnership. If the contributions were treated as guaranteed payments that are derived from the partnership's trade or business, and are for services rendered to the partnership, the contribution would be included in the partner's gross income and would be included in the partner's net earnings from self-employment. Assuming that the partner is an eligible individual, the partner may deduct the amount contributed to the HSA as an adjustment to gross income and the contribution would be included in self-employment income. However, the partner can deduct the amount of the contributions made to his HSA during the tax year as an above-the-line deduction. Notice 2005-8, 2005-4 I.R.B. 368 (January 12, 2005).

B. REAL ESTATE TAXATION

1. Passive Loss Rules Did Not Limit Losses From LLC's Real Property Leasing Activities.

The rental activity loss limitations under Code section 469 did not bar a married couple from deducting losses incurred by their wholly owned LLC from office leasing and related legal/office support activities. The IRS argued that the LLC's leasing activities in connection with a building it owned were per se passive and, therefore, the taxpayers could not deduct their leasing activity losses against ordinary income. The LLC also provided support services to its tenants who were attorneys, including answering phones, taking messages, clerking services, and other secretarial services. The tenants testified that the services provided by taxpayer were unique, that their primary motivation in leasing was to obtain the legal/office support and research services provided by the LLC, and that they would not have leased space from taxpayer if the support services had not been provided.

The court found that the payments by tenants to the LLC were principally for the services provided, not for the real estate leased and accordingly, the taxpayers qualified for the extraordinary personal services exception to the passive activity rules under Treasury Regulation 1.469-1T(e)(3)(ii). The court also determined that the wife materially participated in the LLC's activities based on credible testimony and exhibits showing that she participated well over the requisite 500 hours per year by her daily onsite engagement in, and oversight of, the leasing activities and legal support services. *Al Assafv Commissioner*, T.C. Memo. 2005-14.

2. No Tax Deferral For Like-Kind Exchange Transactions Structured To Avoid the Related-Party Limitations.

In a case of first impression for the Tax Court, it held that a taxpayer could not avoid the like-kind exchange related party rules by using a qualified intermediary. Accordingly, because of the Code section 1031 rules for transactions that were structured to avoid the limitations that apply to exchanges made directly between related parties, the taxpayer, a property development corporation, was not entitled to nonrecognition treatment.

In a series of planned transactions, the taxpayer transferred real properties to a qualified intermediary, which then sold them to unrelated third parties. The qualified intermediary used the sales proceeds and additional funds provided by the taxpayer to purchase like-kind replacement properties for the taxpayer from a corporation in which the taxpayer owned 62.5% of the common shares.

Under the like-kind exchange related party rules, if a taxpayer and a related person exchange like-kind property and within two years either party disposes of the property received in the exchange, the nonrecognition rules do not apply. Although an exception exists for transactions in which tax avoidance was not a principal purpose, the taxpayer failed to show that tax avoidance was not a principal purpose of the exchange or that the transactions as a whole, including the use of a qualified intermediary, were structured for any reason other than to circumvent the related party restrictions under Code section 1031(f).
The evidence in the case showed that the transactions were the economic equivalent of direct exchanges between the taxpayer and its related corporation (with boot from the taxpayer to the related corporation), followed by a sale to an unrelated third party. The interposition of a qualified intermediary could not obscure the end result of the series of related transactions which was an impermissible immediate cash-out of the taxpayer's investment and avoidance of substantial tax. *Teruya Brothers v. Commissioner*, 124 T.C. No. 4 (2005).

3. Sales of U.S. Real Property Interests by Foreign Corporations Will Produce Effectively Connected Income.

A foreign corporation or nonresident alien that sells a United States real property interest ("*USRPI*"), but receives no other income during that year cannot make an election under either Code section 871(d) or Code section 882(d) to have the income from the sale treated as effectively connected with a U.S. trade or business where the taxpayer did not derive any income from the USRPI in the taxable year at issue other than gain from sale of the USRPI. Code section 897(a) already treats gain from the sale of a USRPI as effectively connected income. However, the taxpayer would be entitled to claim deductions attributable to the effectively connected income from the USRPI in the year the gain on the sale was recognized. In addition, if a foreign corporation terminated its business in the United States, the income from the sale of the USRPI would not be deemed to be repatriated from the United States, and, accordingly, the corporation would not be subject to the branch profits tax. Chief Counsel Advice 200504029 (January 7, 2005).

4. Costs of Obtaining Zoning Variances, But Not Zoning Changes, Are Depreciable.

The Tax Court ruled that limited partnerships engaged in real estate development were entitled to depreciation deductions for the costs to obtain zoning variances to construct larger buildings than would otherwise have been permitted, but were not entitled to depreciation for the associated zoning changes to permit unused building density of other properties in the area to be applied to the new buildings. The zoning changes were a prerequisite to the grant of the variances. The IRS had disallowed the claimed depreciation on the basis that the zoning variances and zoning changes were nondepreciable interests in land and did not have a limited useful life.

The Tax Court determined that the zoning variances were allocable to the buildings rather than the land and that the variances had limited useful lives—equal to the useful lives of the buildings to which they related—because the variances would not survive the buildings for which they were granted. Accordingly, the cost of the zoning variances could be added to the depreciable basis of the buildings.

In contrast, because a property owner has no vested right to have its property's current zoning continued, the zoning changes produced benefits of an indefinite and undeterminable duration. Thus, the cost of obtaining the required zoning changes was not depreciable and thus had to be capitalized and treated as part of the cost of the underlying land. *Maguire/Thomas Partners v. Commissioner*, T.C. Memo. 2005-34.

ENDNOTE

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PROPERTY TAX LAW: RECENT DEVELOPMENTS

by John Brusniak, Jr.[1]

Texas Courts of Appeals

TAXPAYER MAY NOT BYPASS PROPERTY TAX ADMINISTRATIVE AND JUDICIAL PROCEDURES CONTAINED IN THE TAX CODE WITHOUT PROVING COMMON LAW EXCEPTIONS TO EXHAUSTION RULE EXIST; TAXPAYER MUST APPEAL TAX DUE DATE DISPUTE TO THE APPRAISAL REVIEW BOARD; SECTION 41.411 CODIFIED COMMON LAW DUE PROCESS RIGHTS; PURE QUESTIONS OF LAW MUST BE BROUGHT TO APPRAISAL REVIEW BOARD FOR DETERMINATION PRIOR TO SUIT IN COURT.

MAG-T, L.P. v. Travis Central Appraisal District, No. 03-04-00151-CV (Tex. App.–Austin, February 3, 2005, no pet. h.). (to be published).

Taxpayer filed a late personal property rendition for tax year 2003 with the appraisal district under the special amnesty statute passed by the legislature. The appraisal district issued a revised 2003 notice of appraised value, after a prior value had been certified, reflecting a higher total valuation for the property. The taxing unit issued a revised tax bill reflecting a higher total due and demanded payment of the revised bill by February 29, 2004. Taxpayer did not file a notice of protest with the appraisal review board, but instead sought injunctive relief from the district court. The appraisal district filed a plea to the jurisdiction contending that the suit should be dismissed for failure to exhaust administrative remedies. Taxpayer contended that it could bypass the administrative remedies based on common law exceptions to the exhaustion rule. The court disagreed, finding that the appraisal district was within its statutory rights to include previously omitted property in the revised notice and that the added valuation constituted omitted property. The court rebuffed taxpayer's argument that the taxing unit had impermissibly shortened the tax delinquency period by finding that the taxpayer should have appealed that decision as well to the appraisal review board. It further held that the taxpayer's due process rights to notice were not violated because the taxpayer had failed to utilize the provisions of Section 41.411 to raise the issue of lack of notice and that Section 41.411 was intended to displace the taxpayer's common law rights. Finally, the court ruled that even if the dispute involved a "pure issue of law" the taxpayer was required to exhaust administrative remedies first because the legislature had given the taxing authorities "exclusive jurisdiction to interpret and act" as to these issues.

PURCHASER AT TAX SALE MUST INTRODUCE INTO EVIDENCE TAX JUDGMENT AND ORDER OF SALE TO PROVE STATUTE OF LIMITATIONS DEFENSE.

Sani v. Powell, No. 05-03-00466-CV (Tex. App.–Dallas, January 26, 2005, no pet. h.). (to be published).

Taxing unit obtained a foreclosure judgment against taxpayer for delinquent taxes. The day before the foreclosure sale, taxpayer filed for bankruptcy protection and an automatic stay issued. The constable was not advised of the automatic stay and sold the property to a third party purchaser. Taxpayer remained in possession of the property and three years later sued to set aside the foreclosure sale. Third party purchaser raised the one-year statute of limitations period contained in Section 33.54(a)(1) of the Texas Tax Code as a defense to the suit. Taxpayer claimed that the third party had not proven the statute of limitations defense at trial because the tax judgment and order of sale were not introduced into evidence. The court agreed with the taxpayer, held that such evidence was required by reading Section 33.54(a)(1) in conjunction with Section 34.01 of the Tax Code and set aside the sale.

TAXPAYER DOES NOT HAVE STANDING TO RAISE THE FAILURE OF A TAXING UNIT TO JOIN LIENHOLDER; FORECLOSURE PURCHASER DOES NOT NEED TO INTRODUCE TAX JUDGMENT AND ORDER OF SALE TO ESTABLISH STATUTE OF LIMITATIONS DEFENSE.

Jordan v. Bustamante, No. 14-03-00633-CV (Tex. App.–Houston [14th Dist.] January 25, 2005, no pet. h.). (to be published).

Taxing unit sued taxpayer for delinquent taxes on two different tracts. Two years after entry of judgment, taxpayer sued the third party tax foreclosure purchaser and the taxing units seeking to set aside the foreclosure sale. Taxpayer alleged that the foreclosure was defective because the taxing units failed to join two lienholders to the suit. In response, the third party purchaser raised the one-year statute of limitations period contained in Section 33.54(a)(1) of the Texas Tax Code as a defense to the suit. Taxpayer claimed that the third party had not proven the statute of limitations defense at trial because the tax judgment and order of sale were not introduced into evidence. The court held that the taxpayer did not have standing to raise the failure to join the lienholders to the lawsuit because the taxpayer was not injured by the failure to join. The court further held that the plain language of the statute did not require such evidence to be introduced and upheld the limitations defense.

ENDNOTE

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STATE TAX: RECENT DEVELOPMENTS

by David E. Colmenero[1]

The following article provides an overview of recent Texas administrative rulings involving Texas sales and use tax and franchise tax issued between the dates of August 15, 2004 and March 15, 2005. With one exception, there were no published court decisions involving franchise or sales tax matters issued within this period.[2]

Franchise Tax

Hearing No. 43,065 (Sept. 3, 2004): Revenues from Sale of Geophysical Data Sourced to Location of Use

In *Hearing No. 43,065*, the Comptroller ruled that revenues from the sale of geophysical and geological data sold to customers pursuant to a Master License Agreement should be sourced to the location where the data is used. The Claimant in that case argued that the receipts from his customers should be treated no differently than receipts for the licensing of computer programs, which pursuant to Rule 3.557(e)(6) are treated as receipts from the sale of an intangible asset and apportioned to the legal domicile of the payor. The ALJ disagreed noting that Section 171.1032(a)(4) provides that gross receipts from the sale of a license in the State are apportioned to this State. Thus, the proper apportionment under the statute is the location of use, not of the payor. The ALJ also noted that Rule 3.557(e)(6), which the taxpayer relied on, appears to be an anomaly and should not be extended to the facts of this case.

The ALJ also rejected an argument by the taxpayer that the location where the data is shot should be regarded as a place of use. The Tax Division on the other hand argued that the billing or shipping address of the taxpayer's customers should be regarded as the place of use. Acknowledging that the Tax Division provided no hearings decisions or tax policy letters supporting its position, the ALJ nevertheless determined that the "ship to" address for the magnetic tape or disc of data was most likely the location of the first use of the data. Because the taxpayer in this case did not present any evidence to the contrary, its refund claim was denied.

Hearing No. 43,749 (Aug. 7, 2004): Reimbursement of Cost Proceeds Represents Gross Receipts for Apportionment Purposes

In *Hearing No. 43,749*, Chief Administrator Law Judge Eleanor H. Kim determined that certain proceeds received by a taxpayer representing reimbursement of cost proceeds were gross receipts for apportionment purposes. The Petitioner in this case is a foreign corporation that entered into an agreement with a separate company ("Company") whereby Company manufactured some of Petitioner's finished product. Petitioner would purchase raw materials from third-party suppliers and would in turn supply those raw materials to Company, which would then manufacture Petitioner's finished products. Petitioner would charge Company an amount for the raw materials that was equal to Petitioner's cost. After manufacturing the finished products, Company sold the products to Petitioner. Petitioner argued that the amount received from Company represented a reimbursement of Petitioner's costs that was not includable in its apportionment formula (both gross receipts and gross receipts everywhere) for franchise tax purposes.

Administrative Law Judge Eleanor Kim determined that when Petitioner supplied the raw materials to Company at a charge, Petitioner sold tangible personal property to Company. The fact that the amount received by Petitioner from Company may have been equivalent to Petitioner's cost did not change the existence of a sale of tangible personal property between two separate entities. The ALJ also found it irrelevant that Petitioner does not normally sell these products in the normal course of its business.

Hearing No. 42,672 (Nov. 19, 2004): Retirement Plan Assets Could Not Be Reduced by Associated Obligations in the Computation of Surplus

In *Hearing No. 42,672*, Chief Administrative Law Judge Eleanor H. Kim ruled that the assets of certain retirement plans could not be offset by the amounts included in two liability accounts used to record activities of the retirement plans for purposes of computing surplus. The Petitioner in this case contested the inclusion of two retirement plans in the computation of surplus. Petitioner used two liability accounts to record activities of its retirement plans and two separate accounts that reflected retirement plan assets. The amounts in the retirement plan asset accounts equaled the amounts in the retirement plan liability accounts.

Recognizing that the retirement plan liabilities in question did not meet the statutory definition of "debt" and therefore would not otherwise reduce the corporation's surplus for taxable capital purposes, Petitioner nevertheless argued that the retirement plan should be offset against the associated liabilities. Petitioner also conceded that it was required to separately state assets and liabilities of the retirement plans on its balance sheet for financial reporting purposes.

The Administrative Law Judge rejected Petitioner's argument in this case. Citing a series of Comptroller decisions, the ALJ determined that, under existing precedent, the Comptroller's interpretation of the relevant statutory provisions prohibits the offset sought by Petitioner. For this reason, Petitioner's contention was denied.

The Administrative Law Judge also rejected an argument by Petitioner that it should be permitted to adjust the computation of Texas receipts as initially reported. Petitioner provided summary schedules which showed that, if various reported errors were corrected, Texas receipts for the years at issue were overstated in the audit. The Tax Division argued that the summary schedules were insufficient and requested that Petitioner produce summaries with sales broken out by all states and totaled. Petitioner did not produce the documents and responded that such request was unreasonable because it would require Petitioner to perform over 16,000 queries of its database, which could generate over 1 billion transactions to review. The ALJ determined that the Tax Division's request was nevertheless tailored to determine the accuracy of the summary schedules and not facially unreasonable. Noting that Petitioner had the burden of proving its entitlement to the credit itself, the ALJ determined that Petitioner's failure to produce the requested documents disqualified Petitioner for the credit.

Letter Ruling 200409839L (Sept. 10, 2004): Business Located in Federally Designated Empowerment Zone is Eligible for Strategic Investment Areas Credit

In Letter Ruling 200409839L, Comptroller Carol Keaton Strayhorn personally replied to a taxpayer's inquiry regarding the franchise tax credits for strategic investment areas. The taxpayer had a business located in a federally designated empowerment zone and asked the Comptroller to affirm that his business was eligible for the SIA franchise tax credits. Taxpayer was a car manufacturer, whose business would be located in a city located within a federal empowerment zone, which the taxpayer noted is a subset designation of a federal urban enterprise community. Taxpayer also noted that one of the areas included in the statutory definition of an SIA is an area that is federally designated as an urban enterprise community. Taxpayer further noted that the enabling statute for Texas enterprise zone program was updated last session to recognize an empowerment zone designation as a subset of the federal enterprise community program. The Comptroller agreed with the taxpayer that an empowerment zone is a subset of the enterprise community program and that reference to a federal enterprise community can include areas federally designated as an empowerment zone.

Sales and Use Tax

Hearing No. 44,211 (Dec. 7, 2004): Equipment Used in Wholesale Commercial Bakery Held Ineligible for Manufacturing Exemption

Hearing No. 44,211 represents a further articulation of the manufacturing exemption as well as the Comptroller's continuing tendency to construe certain provisions of the exemption very narrowly. The Petitioner in this case is a wholesale commercial bakery that purchased equipment for use in removing excess debris from and in sanitizing pans and molds used in baking Petitioner's products. The taxpayer also purchased warehouse management software and scan guns that were used in tracking all in-coming ingredients, packaging and finished goods. The taxpayer argued that the washers, software and scan guns qualify for the manufacturing exemption because they were required by federal and other public health requirements. The Taxpayer also argued that the filtration and waste water recycling systems of the washers qualified for the manufacturing exemption as property installed to "reuse and recycle wastewater systems generated within the manufacturing operation."

The Comptroller disagreed with the taxpayer's first argument on the basis that the taxpayer failed to show the requisite level of necessity under federal law. With respect to the washers, the Comptroller ruled that Petitioner did not show by clear and convincing evidence that the washers were required by public health regulations. Rather, Petitioner showed only that sanitation of the pans was required. As for the computer software and scan guns, the Comptroller likewise determined that Petitioner did not show by clear and convincing evidence that the tracking system used by Petitioner was required by public health regulations. Petitioner established only that tracking was required.

The Comptroller also disagreed with Petitioner's argument that the filtration systems and waste water recycling systems of the washers qualified for the manufacturing exemption as property installed to "reuse and recycle wastewater systems generated within the manufacturing operation." The Comptroller determined that this exemption did not apply because the wastewater was not generated from the actual manufacturing process. Rather, the wastewater was generated from the pan washing process, which the Comptroller determined to be one step removed from the actual manufacturing process.

Hearing No. 42,532 (Dec. 2, 2004): Charge for the Storage of Magnetic Tapes Was Not Part of Taxable Data Processing Service

In *Hearing No. 42,532*, the Comptroller ruled that charges by a taxpayer for the storage of backup tapes did not constitute a taxable data processing service. The Petitioner provided a type of automated teller service to interstate truckers (referred to as NTS Services). Petitioner entered into an exchange agreement with Company B to swap businesses. Under the terms of that agreement, Petitioner agreed to continue operating the NTS Services business including the data processing of transactions for a transitional period. Under the terms of the exchange agreement, Petitioner was required to retain and store transaction data offline on magnetic tape or other appropriate media at an offsite storage facility at Company B's expense. Petitioner collected sales tax from Company B on the data processing services. It did not, however, collect sales tax on the tape storage charges.

The administrative law judge determined that the charge for the storage service provided by Company B did not constitute a part of the taxable data processing services provided by Petitioner. Citing to *Rylander v. San Antonio SMSA, Limited Partnership*, 11 S.W.3d 484 (Tex. App.—Austin, 2000, no writ), the administrative law judge determined that the clear language from the exchange agreement established that Company B was seeking both the data processing service and the tape storage service. The ALJ noted that Petitioner provided the data processing service and secured a tape storage service from a third party. The fact that the third party storage charges were passed through to Company B did not change the nature of the transaction, particularly in view of the fact that the exchange agreement provided that such storage charges would be provided at Company B's expense. Accordingly, the tape storage charges represented unrelated non-taxable services pursuant to Rule 3.300(d)(1).

Hearing No. 44,050 (Aug. 24, 2004): Tax Collected Not Remitted Alone Does Not Support Imposition of Fraud Penalty

Hearing No. 44,050 appropriately limits the scope of some recent rulings which suggest that a large amount of tax collected not remitted alone suffices to establish the requisite element of intent to support the imposition of the fraud penalty. The Petitioner in this case was a lumber distributor who had been in business for several years. The Petitioner's president handled all of the administrative affairs for Petitioner including the preparation of sales tax reports.

Throughout the audit period, the Petitioner's president appears to have made two significant errors in preparing the sales tax reports. The first error was committed by reporting total sales based on an accrual method while reporting taxable sales by taking the then current checkbook balance as the amount of sales tax collected (i.e. based on a cash basis method). The second error was committed when he neglected to add back to the checkbook balance amounts paid out for purchases, expenses, or payroll. This latter error resulted in the underreporting of tax collected even on a cash basis method. Although the amount is not specifically stated in the published decision, it appears that the total amount of tax collected not remitted was substantial.

According to the undisputed facts, Petitioner was not aware that it was not remitting the correct amount of tax or the extent of its underreporting. Apparently, Petitioner only knew its financial position by comparing receivables to payables and had no formal profit or loss statements. Petitioner discovered its error only after the company CPA reviewed Petitioner's accounting method in preparation for a sales tax audit by the Comptroller.

The Tax Division argued that the fact that Petitioner admitted it had collected a substantial amount of money in sales tax that it did not remit provided clear and convincing evidence of Petitioner's intent to evade paying sales tax. In support of its contention, the Tax Division cited to prior Comptroller decisions suggesting that the gross underreporting of taxable sales is sufficiently indicative of intent to evade tax to warrant assessment of the fraud penalty.

The administrative law judge disagreed with the Tax Division noting that the gross underreporting of taxable sales will support imposition of the fraud penalty only where there is no other plausible explanation provided by the taxpayer. In this case, unlike the cases cited by the Tax Division, the ALJ ruled that Petitioner presented a plausible explanation as to how the errors occurred (i.e., Petitioner used the hybrid cash-accrual accounting system). The ALJ also noted that the credibility of Petitioner's president and its CPA was bolstered by the fact that once the error was discovered, Petitioner readily admitted that tax had been collected and not remitted and even produced a schedule showing the correct amount. The ALJ also noted that there was no direct evidence that Petitioner's president intended to evade payment of the tax or that he was even aware of the failure to remit the correct amount of tax collected.

Because the Tax Division presented no evidence other than the size of the amount owed to show Petitioner's intent, the Tax Division failed to meet its burden to show by clear and convincing evidence that Petitioner in this case intended to evade payment of tax. For this reason, imposition of the 50% penalty was overruled.

Hearing No. 43,986 (Sept. 17, 2004): Acid Wash Services Determined to Constitute Non-Taxable Repair or Restoration of Residential Real Property

Hearing No. 43,986 addresses the taxability of certain acid wash services provided by the taxpayer. The Petitioner in this ruling provides an acid wash service to clean the interior surface of a pool in order to restore the pool's plaster. The ALJ determined that the acid wash service provided by the Petitioner is not a "pool cleaning and maintenance service" as defined in Rule 3.356 and as contended by the Tax Division, but rather represents the repair or restoration of residential real property as defined in 3.357. The ALJ noted that the evidence demonstrated that Petitioner's process is used as a substitute for repainting the plaster, is not a routine cleaning or maintenance service, is substantially more expensive than a routine cleaning or maintenance service and is only used as a last resort. Under these facts, the ALJ determined that Petitioner's services are not subject to sales tax.

Hearing No. 43,144 (Sept. 8, 2004): Contractor May Not Use Tax Collected in Error to Offset Tax Due on Purchases

Hearing No. 43,144 reiterates the Comptroller's longstanding policy regarding a contractor's ability to offset tax due on taxable purchases with tax collected in error. The Comptroller's policy represents a trap for the unwary as well as perhaps one of the greatest inequities in the Texas tax system regarding tax collected in error.

The Petitioner's primary business activity during the audit period involved the remodeling and repairing of residential real property. The Petitioner also sold items directly to its customers at retail. Throughout the audit period, Petitioner purchased materials tax-free both for use in remodeling and repair jobs and for sales directly to customers. Petitioner collected sales tax on a portion of its lump sum contracts. Following an audit, the Comptroller assessed tax on the purchase of materials used in the lump sum contracts. Petitioner argued that the adjustment for tax on the purchase of taxable items should be deleted from the audit because it collected and remitted tax on these scheduled materials when they were used in the Petitioner's repair or remodeling jobs or sold over the counter from its retail outlet. Petitioner also argued that if the adjustment were upheld, the materials would be affectively subjected to double taxation.

The administrative law judge disagreed with the Petitioner's contention. The ALJ noted that under the Comptroller's rules a person who repairs or remodels residential real property and who incorporates materials into the realty is considered a contractor. A contractor who makes a lump sum charge for both the labor and incorporated materials is considered the consumer of the incorporated materials and must pay tax to suppliers when purchasing materials to be incorporated into the realty. In addition, a lump sum contractor may not collect tax from a customer on any portion of the lump sum charge. Any amounts collected as taxes on a lump sum charge are held "in trust for the benefit of the state" even if collected in error. Citing to the Comptroller's longstanding policy as reflected in a number of decisions, the ALJ noted that a contractor who collects tax in error may not use that amount to offset his liability for taxes owed on purchases until the contractor first refunds the amounts collected in error to customers.

Hearing No. 42,681 (Sept. 2, 2004): Scaffolding Charges Represent Rental of Tangible Personal Property Rather Than Purchase of Service

In *Hearing No. 42, 681*, the Comptroller addressed the taxability of certain charges for scaffolding provided to a taxpayer. Petitioner in this case operates refineries in two different cities in Texas. Petitioner requires scaffolding to perform work on refinery units during "shut-downs" because of the height involved.

When Petitioner determines that it requires scaffolding, it will typically inform its vendor of the location where the scaffolding is needed, the type of work to be done on the scaffolding, and the number of refinery employees that will be on the scaffolding while performing shut-down work. The vendor will then provide the scaffolding and the employees who design and assemble the scaffolding at the location designated by Petitioner. The scaffolding vendors maintain full-time employees at Petitioner's refineries during the shut-down periods. In addition to providing designing, assembling and disassembling services relative to the scaffolding, at the end of each shift, these employees also perform safety inspections and make necessary adjustments on the scaffolding currently being used by the Petitioner's employees. After the Petitioner is done with the use of the scaffolding, it is disassembled by the vendor's employees. Petitioner argued that on these facts, the amounts charged by its vendors should be regarded as the purchase of scaffolding services rather than the rental of tangible personal property.

The administrative law judge disagreed. Citing to the "essence of the transaction" doctrine, the Comptroller determined that, while the design, assembly and disassembly of scaffolding requires expertise, the ultimate object of the transaction is the tangible personal property/scaffolding needed to reach areas of the refinery units not otherwise accessible. The design, assembly, and disassembly services are merely incidental to the rental of tangible personal property according to the ALJ.

The ALJ also rejected Petitioner's argument that the rental of the scaffolding should be viewed as the rental of tangible personal property with an operator which is generally regarded as a non-taxable service rather than the rental of tangible personal property. According to the ALJ, the vendor's employees do not represent operators of the scaffolding equipment. These employees merely assemble the scaffolding at the location selected by the Petitioner who then uses the scaffolding to achieve its desired result. Unlike cranes, bulldozers and backhoes, which require operation while being used, the scaffolding equipment in this case, stated the ALJ, requires no operation when in use. This rule was therefore inapplicable.

Hearing No. 43,732 (Nov. 29, 2004): Conveyor and Racking Systems Installed to Newly Constructed Building Qualify as Non-Taxable New Construction

In *Hearing No. 43,732*, the Comptroller addressed a refund claim made in connection with two contracts for the fabrication and installation of specially manufactured racking and conveyor system. The claimant in this case owned and operated a newly constructed distribution center in Texas that was designed by the claimant to shelter certain racking and conveyor systems and the administrative offices used for managing the distribution center. Prior to the construction of the distribution center, claimant entered into a contract with two separate entities to purchase a racking system and a conveyor system. Under the terms of the contracts, each vendor was required to design, fabricate and install the systems at the distribution center. Each of the contracts was a "lump sum contract" under which there was no separation of charges for labor and materials. The facts also establish that, until the racking and conveyor systems were installed and operating, claimant could make no use of the building. In addition, the racking and conveyor systems were installed during the new construction phase of the distribution and before claimant accepted or occupied the premises.

The ALJ agreed with the claimant that the cost of the racking and conveyor systems qualified as non-taxable new construction. The ALJ cited to a number of factors, including (1) claimant constructed a modernized distribution center in which each system would play a critical part; (2) the distribution center was specifically designed to house the systems, and the installation of the systems occurred during the new construction stage of the building; (3) claimant intended to affix the systems permanently to the real property, which was supported by the manner in which both systems were affixed to the realty and the adaptation of the systems to the building; and (4) after the attachment, the systems were intertwined functionally and physically and could not be removed without destroying the real property and the utility of the building. On these facts, the ALJ concluded that claimant established that the systems were to remain permanently in place and that the contracts to install the systems constituted contracts for new improvements to real property.

The ALJ therefore agreed that the claimant was entitled to a refund of tax paid on the conveyor and racking systems, contingent upon verification that claimant, in fact, paid the taxes for which it sought a refund.

Hearing No. 31,842 (Sept. 17, 2004): Piping Used in Sulfur Mining Qualifies for Manufacturing Exemption Under Pre-1997 Law

Hearing No. 31,842 addresses the applicability of the manufacturing exemption to certain piping used in the mining of sulfur under the pre-1997 version of the manufacturing exemption. The claimant in this case used a very specialized method for mining sulfur at depths ranging from 300 to 2,500 feet below the surface, referred to as the Frasch method. Under this method, the taxpayer used a highly specialized piping system in which a series of pipes were included within each other with each serving a different purpose in the mining process. One pipe was used to pump superheated water into the sulfur formation, causing the sulfur to melt into a liquid form. Another pipe would inject air into the formation causing the melted sulfur to rise to the surface. A separate pipe, also included within this piping system, was used to transport the melted sulfur to the surface. Claimant argued that the piping qualified for the manufacturing exemption under the authority of *Sharp v. Chevron Chemical Company*, 924 S.W.2d 429 (Tex. App.—Austin, 1996, writ denied). The Tax Division, on the other hand, argued that the manufacturing did not apply because the piping was not part of a self-contained, unified manufacturing process or an integrated plant.

The ALJ disagreed with the Tax Division and upheld the Claimant's claim for refund. According to the ALJ, adding superheated water to create a physical or chemical change in the sulfur constitutes a processing activity that brought the piping equipment within the manufacturing exemption. The ALJ also determined that all of the piping in this case was part of a self-contained, unified manufacturing process and was not used solely for intraplant transportation purposes. Accordingly, the piping qualified for the manufacturing exemption under Section 151.318 and the Chevron case.

Hearing No. 39,572 (May 7, 2004): Downhole Equipment Used to Bring Oil to Surface Does Not Qualify for Manufacturing Exemption Under Pre-1997 Law

Hearing No. 39,572 likewise involves application of the manufacturing exemption as it existed prior to October 1, 1997. At issue in this ruling is the taxability of certain below ground equipment used to facilitate the process of bringing oil to the surface. The equipment consisted of certain "below-ground equipment" used to maintain pressure and facilitate the flow of oil and gas toward ultimate recovery. Gas separators were used to promote oil and gas separation. Emulsion breakers/demulsifiers were used in connection with the separation of water from oil. Paraffin inhibitors were used to prevent paraffin deposits that might inhibit production. Carbon dioxide injection was used to affect the viscosity of, and displacement of, crude oil and to enhance its mobility.

The Claimant argued that the equipment qualified for the manufacturing exemption because it was used in or during processing performed by the gas separators and by carbon dioxide injection, the emulsion breakers and the paraffin inhibitors, which effect physical and chemical modifications to oil and gas. Claimant argued that the below-ground equipment was exempt because all equipment that "acts upon" the product once processing starts falls within the exemption, regardless of whether each item is engaged in processing.

The ALJ disagreed. The ALJ cited Comptroller Decision No. 39,936 (2003) where the Comptroller determined that downhole equipment of the same type at issue in this case was not exempt citing its long-standing policy that the "act of bringing oil to the surface of the earth is not processing, fabrication or manufacturing." The ALJ noted that the taxpayer in that case made a similar argument regarding the downhole equipment.

Hearing No. 39,311(July 12, 2004): Independent Contractors Establish Nexus for Out of State Contractor

Hearing 39,311 reiterates the Comptroller's long-standing policy that independent contractors located within the State suffice to create nexus for out-of-state entities. Petitioner in this hearing is a commercial flooring contractor that sells and installs flooring material primarily to and for national retailers. Throughout the audit period, Petitioner entered into contracts with national retail chains pursuant to which Petitioner agreed to (a) sell and deliver flooring materials to the retailer's existing Texas stores(s), or (b) install flooring materials at existing Texas location(s), or (c) provide both the materials and labor for flooring jobs at existing Texas store(s). In addition, Petitioner provided repair and maintenance services to Texas customers during the audit period and also sold and installed flooring at new construction sites.

Throughout the audit period, Petitioner maintained subcontractors to perform the labor portion of its Texas remodeling jobs. These subcontractors also provided repair and maintenance services in Texas. One of the arguments asserted by Petitioner was that Petitioner did not have substantial nexus with the State of Texas. It also argued that the audit assessment was improper because its vendors had already remitted the taxes at issue. Petitioner further asserted that its subcontractors were responsible for collection and remittance of sales tax.

The ALJ rejected Petitioner's arguments. As for the first contention, the ALJ cited to *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960) and *Quill v. North Dakota*, 504 U.S. 298 (1992), in ruling that Petitioner's activities in Texas were sufficient to establish nexus in this state, even if performed by subcontractors. The ALJ rejected Petitioners second argument noting that the services provided by Petitioner at existing retail stores constitutes taxable commercial repair and remodeling. As for Petitioner's argument to the effect that its subcontractors were responsible for collection and remittance of sales tax, the Comptroller ruled that it was not bound by the terms of Petitioner's agreement with a third party.

The ALJ also rejected an argument to the effect that certain tax collected and not remitted on sales contracts represented a mere recoupment of tax paid to manufacturers. The auditor determined that Petitioner had collected but failed to remit sales tax on certain contracts. The facts also established that Petitioner had paid tax on materials purchased from some of its manufacturers. The ALJ rejected this argument noting that Petitioner was unable to trace tax paid to its manufacturers to commercial remodeling jobs in Texas or that the manufacturers held sales tax permits in Texas and furthermore that this argument did not take into account tax collected on the mark-up.

Hearing No. 44,035 (July 7, 2004): Refund Claim for Tax Collected in Error Does Not Relate Back to Reporting Period for Penalty Purposes

Hearing No. 44,035 addresses the effect of a claim for refund of tax collected in error and previously remitted to the Comptroller on the imposition of penalty and interest for the same or later periods. Petitioner in this case collected tax in error and remitted it to the Comptroller. It was later audited for sales and use tax compliance. While the audit was in progress, Petitioner filed a claim for refund for the tax previously collected in error and remitted to the Comptroller. After filing the claim for refund, Petitioner issued a credit memo that was acknowledged and accepted by the Comptroller. The Comptroller thereafter issued a Texas Notification of Audit Results in which it imposed a penalty for periods within the audit period for which returns were not timely filed and waived penalty for other periods. The refund claim related to periods that were either the same as or that predated the periods for which penalty was imposed.

Petitioner argued that penalty and interest in this case should be determined after the amount due for each period within the audit is reduced by the claim for refund attributable to that period. Petitioner contended that once a claim for refund is established it should be applied to the specific period to which it applies and treated as an overpayment in that period that offsets any tax liability assessed in the corresponding period.

The ALJ disagreed with Petitioner. According to the ALJ, Petitioner established its right to the money only when the money was refunded to its customers via the credit memo. Because the overpayment occurred after the end of the audit period, the payments could not be allocated on a period-by-period basis. The ALJ also noted that this rule creates consistency between taxpayers who file refund claims and those choose to take a credit on their returns (i.e., in both cases no retroactivity for credits is recognized).

Hearing No. 43,925 (July 20, 2004): Tax Collected in Error May Not Be Reduced by Administrative Fee

Hearing No. 43,925 addresses the question of whether tax collected in error and refunded to a customer may be reduced by an administrative fee. Petitioners in this case were sellers of shoes, boots and clothing accessories. In connection with sales to customers for export, sales tax was collected on the sales, and upon proof of export by the customs broker, refunded to the customer less and administrative fee. The Comptroller's auditor determined that the amounts retained as administrative fees represent tax collected in error.

Citing to various provisions of the Tax Code and the Comptroller's Rules, the ALJ determined that there is no provision in either the Tax Code or the Comptroller's Rules allowing a deduction for an "administrative fee" or other allowance from amounts collected as taxes. The ALJ therefore concluded that the amounts initially collected as taxes in this case retained their character as such and had to be refunded to Petitioners' customers before any refund or credit could be properly granted or taken. Because taxes collected are held in trust for the State, the administrative fee amounts represented monies due and owing to the State of Texas as a matter of law. The ALJ rejected other challenges raised by Petitioners to the representativeness of the sample.

Hearing No. 43,963 (Dec. 3, 2004): Removal of Industrial Waste Held to Constitute Non-Taxable Service

In *Hearing No. 43,963*, the Comptroller determined that certain services for the removal of industrial solid waste constitute a non-taxable service. The Petitioner is a manufacturer of synthetic rubber and latex that constructed a wastewater treatment system to treat wastewater generated from its Texas facility. In order to comply with state and federal law, Petitioner contracted with a third party ("Company") to "remove sludge, dewater, load and transport dewatered cake to a Class II landfill for disposal." Petitioner argued that the services provided by Company constitute the removal of industrial discharges subject to regulation and are excluded from taxable real property services under Section 151.0048(a)(3)(E).

Citing to *Rylander v. Associated Technics Co*., 987 S.W.2d 947 (Tex. App. – Austin 1999, no pet.), the ALJ agreed with Petitioner. The ALJ noted that in *Associated Technics* the Court held that the entire asbestos-abatement process at issue in that case constituted the removal and disposal of hazardous waste. In so holding, the Court rejected the bifurcated approach taken by the Comptroller which treated the asbestos abatement services as consisting of both taxable repair and remodeling services and the non-taxable removal of industrial solid waste. The ALJ determined that the facts of this case were analogous to those in *Associated Technics*, noting that the primary objective sought was the removal of the sludge.

Hearing No. 44,195 (July 8, 2004): Four Year Statute of Limitations Applies to Fiduciary Liability Even Where Corporation Has Filed No Returns

Hearing No. 44,195 provides an opinion in favor of taxpayers that should come as some relief to corporate officers. In this ruling, the ALJ determined that the four year statute of limitations ran for purposes of asserting liability against the officer of a company for tax collected and not remitted under Section 111.016(b) even though the corporation filed no returns. The Petitioner in this case was the president and secretary of a company that collected sales tax that was not remitted to the Comptroller. The company never filed sales tax returns during the audit period. Petitioner argued that the statute of limitations barred the collection of sales tax against him. Petitioner also argued that he was not liable for the tax as officer or director of the company.

The ALJ agreed with Petitioner's first contention. The ALJ noted that under Section 111.205(a)(2), the four year statute of limitations does not apply if no report for tax has been filed. However, this exception, stated the ALJ, did not apply to Petitioner because the Company, rather than Petitioner, was required to file the sales tax reports. As such, the four year statute of limitations applied. Because the assessment occurred after the limitations period had run, it was barred.

<u>Procedural Issues</u>

Letter Rule 200412947L (Dec. 20, 2004): Taxpayer May Raise Any Issues, Including Credit Issues, in Timely Filed Petition for Redetermination Despite Statute of Limitations

In Letter Ruling 200412947L, the Comptroller addressed a question raised by an attendee at the November 12, 2004 meeting of the State Taxation Committee of the State Bar of Texas. The attendee asked whether a taxpayer could raise any issue in the statement of grounds of a petition for redetermination including credit issues where the agency issues a notice of audit results on the last day of the limitations period. The Comptroller determined that under Section 111.009, the Comptroller has always allowed a taxpayer who timely requests a redetermination to raise any issues challenging the assessment and to also raise any credit issues to offset the same. The Comptroller noted that Section 111.009 was left undisturbed by House Bill 2425 which became law as part of the 78th Legislature in 2003. Thus, the Comptroller's position remains that a taxpayer has 30 days within which to raise redetermination and credit issues for the period involved.

However, the Comptroller further noted that the amendment to Section 111.207 limits tolling to the issues contested in a proceeding. Thus, the 30-day provision in Section 111.009 sets the statutory deadline for raising contested issues. Beyond this period, there is no statutory provision permitting a taxpayer to raise credit issues in a redetermination hearing, notwithstanding the Comptroller's Rule 1.7 which allows a statement of grounds to be amended during the hearings process.

Hearing No. 42,064 (Sept. 1, 2004): Notification of Sampling Procedures Not Required Before Implementation of Short Test

In *Hearing No. 42,064*, the Comptroller addressed a challenge to the timely issuance of a Notification of Sampling by the auditor. The facts established that the Notification was issued after the auditor had conducted a "short test" that included 8 of the 31 days that were included in the sample. After discovering material errors in this short test period, the auditor issued a Notification of Sampling to Petitioner informing it that a sample would be used. Petitioner argued that the sample performed by the auditor was invalid because the Notification of Sampling was not properly issued. In particular, Petitioner argued that the Notification did not comply with Section 111.0042(c) which provides that "before using a sample technique to establish a tax liability, the comptroller or his designee must notify the taxpayer in writing of the sampling procedure to be used."

The ALJ disagreed with Petitioner and upheld the Notification as valid. The ALJ determined that Section 111.0042(c) of the Tax Code requires that the Notification be issued prior to the establishment of the liability to provide the taxpayer with an opportunity to object to the sampling procedures prior to their implementation. However, to determine what sampling procedures to use, an auditor must first perform a short test, according to the ALJ, in order to verify that the proposed methodology will result in accurate results. Thus, stated the ALJ, the only reasonable interpretation of Section 111.0042(c) is to require that the Notification be issued after the proposed methodology is determined to be appropriate but before it is actually implemented. The ALJ also rejected a challenge by Petitioner to the representativeness of the sample.

ENDNOTES

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2 For a discussion of *May Dep't Stores Co v. Strayhorn*, 2004 WL 1898244 (Tex. App—Austin), which was issued on August 26, 2004, please refer to the October 2004 edition of The Texas Tax Lawyer.

TAX-EXEMPT ORGANIZATIONS: RECENT DEVELOPMENTS

by Tyree Collier[1]

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

A. LITIGATION

1. Class-Action Lawsuits against 501(c)(3) Hospitals. As reported in previous issues, a coordinated group of plaintiffs attorneys filed class-action lawsuits against hundreds of 501(c)(3) hospitals and healthcare systems across the nation in 2004. The petitions allege primarily that the hospitals, in dealing with uninsured patients, have failed to live up to community obligations that result from their federal and state tax exemptions and their receipt of charitable contributions. In the first two months of 2005, federal courts have continued dismissing claims in those cases. All of the early decisions have been in favor of the 501(c)(3) hospitals and healthcare systems. Nevertheless, Richard Scruggs, the Mississippi attorney who has served as a spokesman for the plaintiffs attorneys, said in late February that the plaintiffs will continue to pursue their claims in federal court because they are convinced the 501(c)(3) hospital defendants have not acted properly. But, he said, they will also put more effort into pursuing their claims in state courts as well.

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

1. Joint Committee on Taxation Issues Report Including Exempt Organization Proposals. The Joint Committee on Taxation released a 435-page report in late January detailing situations where tax revenue should be collected, but is currently not being collected. Over 100 pages of the report address charities. Those pages include discussions of charitable deductions being overvalued, charities being used in illegal tax shelters, charities being used in insider transactions, and charities paying unreasonable expenses and excessive compensation. The issues covered in the discussion are somewhat similar to the issues raised by the Senate Finance Committee in its white paper on exempt organization issues that was released in June 2004. Several of the more significant recommendations made by the Committee include the following.

   A. Congress should enact additional exemption requirements for credit counseling organizations.

   B. Limitations should be imposed on commercial-type insurance provided by fraternal beneficiary organizations.

   C. Charities should be required to re-apply for exemption every five years and annual notices (filed with the IRS) should be required for organizations that are not required to file Form 990.

   D. Intermediate sanctions penalties in Section 4958 should be expanded and the rules should be revised to reduce the ability to rely on a rebuttable presumption of reasonableness.

   E. The deductibility of charitable contributions of various types of property should be restricted, with deductions limited to the lesser of basis or fair market value for contributions of property other than publicly traded securities.

   F. Forms 990-T should be required to be made available to the public.

2. Panel on the Nonprofit Sector Issues Interim Report on Exempt Organization Reforms. A panel of foundation and other charity executives was convened by Independent Sector in October 2004 to study and propose potential reforms of the tax laws applicable to nonprofit organizations with a focus on Section 501(c)(3) charities. The Panel released an interim report on March 1 at a joint press conference with Senate Finance Committee Chairman Charles Grassley, where Senator Grassley praised the Panel and said the Finance Committee will take the report under consideration. Senator Grassley also commented that the report recently issued by the Joint Committee on Taxation staff was helpful. The recommendations made by the Panel include recommendations for actions by charitable organizations, recommendations for actions by the IRS, and recommendations for legislative action. The Panel's report is important because it represents the views of a significant group of charities regarding what reforms are really needed. It should also give Congress a better idea of which specific reform proposals may require hard political battles and which proposals may not. The report can be reviewed at www.nonprofitpanel.org. The Panel's recommendations include the following:

   A. Form 990 Changes. The Panel proposes that an exempt organization's board of directors or at least a board committee review the Form 990 before it is filed. The Panel proposes that the IRS require the Form 990 to be signed by either the CEO, the CFO, or the highest ranking officer, and by a trustee if the organization is a trust. The Panel recommended that increased penalties on organizations as proposed by the Senate Finance Committee staff not be enacted, but rather that the IRS do a better job of imposing existing penalties when abuses actually occur. The Panel also recommended that the IRS be able to suspend the exemption of organizations that fail to file required returns for two consecutive years after notice from the IRS. The Panel also recommended that penalties be created that can be imposed on Form 990 return preparers. The Panel recommended that electronic filing of Forms 990 be made mandatory, and that the Form 990 be coordinated with state filing requirements. Section 501(c)(3) organizations not required to file

Form 990 because of low annual receipts would nevertheless be required to file an annual notification with the IRS so that IRS records will be more accurate. The notification would be made available to the public in the same manner as Form 990. The Panel also advised that it would make recommendations as to the substance of Form 990 in its final report.

B. Financial audits and reviews. The Panel recommends that a charitable (i.e., Section 501(c)(3)) organization required to file Form 990 that has $2 million or more in total annual revenues be required to have a financial audit performed each year. Organizations required to file Form 990 that have at least $500,000 in annual revenues would be required to have financial statements reviewed by a CPA. All organizations required to have audited financial statements would be required to attach those statements to their Form 990. The Panel recommended that the federal tax laws not require that charitable organizations rotate auditors periodically.

C. Conflicts of Interest. The Panel recommends that every nonprofit organization adopt a conflict of interest policy consistent with their state law and that all nonprofit organizations should encourage other nonprofit organizations to adopt conflict of interest policies. The Panel recommends that Form 990 require a disclosure as to whether an organization has a conflict of interest policy, but that no further legal requirements be enacted regarding conflicts of interest policies.

D. Audit Committees. The Panel recommends that charitable organizations include persons on the board who have "some financial literacy" and that every organization with audited financial statements consider establishing a separate audit committee. A sector-wide effort should be made to educate nonprofit organizations about the importance of the audit function.

E. Reporting of Suspected Misconduct or Malfeasance. Charitable organizations should establish policies that encourage employees to come forward with any credible information on illegal practices or violations of adopted policies within the organization.

F. Donor advised funds. The Panel recommends that the term "donor advised fund" be statutorily defined to provide a better basis for targeting rules to such organizations. Public charities should be prohibited from making grants from donor advised funds to private non-operating foundations. There should be minimum activity rules for donor advised funds. There should be certain limits on their expenditures, and grantees should be required to certify that the funds they receive are not used to benefit the donors who recommended them.

G. Valuation of contributions. The Panel continues to study the issue of how to value contributions of property to charities, but expressed "deep reservations" about a proposal of the Joint Committee of Taxation that the deduction of contributions of property other than publicly traded securities be limited to the lesser of basis or fair market value.

H. Penalties on self-dealing and other violations. The Panel proposed that penalties on individuals who commit self-dealing or other violations be increased. The Panel also proposed changes to the IRS's ability to abate penalties, but with specific recommendations to come in the final report. The Panel recommended that changes be made to foundation manager penalties so that they are more likely to be imposed, but yet not to make the changes so stringent that responsible qualified persons would be concerned of unfair imposition of penalties and thereby refuse to serve on boards.

I. Supporting Organizations. The Panel recommended that Congress not adopt the Senate Finance Committee staff's proposal to eliminate Type 3 supporting organizations (i.e., those that are "operated in connection with" their supported organizations). The Panel will include recommendations for anti-abuse rules in its final report.

J. Tax Shelters. The Panel recommended that anti-abuse provisions be developed to prevent charitable organizations from participating in listed transactions. The Panel will propose specific rules in its final report.

K. State Enforcement. The Panel recommended that states enact laws incorporating federal standards so that state enforcement agents can essentially enforce federal tax requirements by enforcing their own state laws.

L. Funding of Enforcement. The Panel recommended that Congress allocate more funds for enforcement of exempt organization laws and that funds generated from enforcement of exempt organization provisions be retained for further enforcement activities.

M. Sharing of Information. The Panel recommends that Congress allow state charity officials such as state attorney generals the same access to federal tax information as is currently afforded to state revenue agents.

3. Texas Charity Hospital Investigation. A spokesman for the Texas Attorney General's office said recently that the AG's office has an ongoing investigation into many Texas charity hospitals to determine whether the hospitals are providing sufficient charity care for indigent patients. The AG's office made the statement in connection with a January announcement that it had entered into an agreement with Zale Lipshy Hospital of Dallas requiring that hospital to create an endowment specifically for indigent health care.

ENDNOTE

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POTENTIAL CHANGES TO THE SELF-EMPLOYMENT TAX OF PARTNERS, LLC MEMBERS AND S CORPORATION SHAREHOLDERS

by Michael W. Barton[1]

Introduction

Earlier this year, the Joint Committee on Taxation submitted a proposal to Congress that would significantly modify the employment tax for partners, limited liability company ("LLC") members and S corporation shareholders (the "Proposal").[2] While the Proposal has only recently been sent to Congress, the focus on improving Social Security could persuade lawmakers to give the Proposal serious consideration. The Proposal reveals Congress' focus on reducing abuses that have existed for years with regard to employment taxes, and Congress' desire to capture significant amounts of revenue that are currently going uncollected. The Proposal also warns tax practitioners that changes in the area of employment tax for partners, LLC members and S corporation shareholders could be on the horizon.

Under current Federal tax law, employees and self-employed individuals are treated differently for employment tax purposes. For example, self-employed individuals, such as sole proprietors, are subject to self-employment tax on what is called their "net earnings from self-employment," and they are responsible for the payment of their entire employment tax liability.[3] Members of partnerships and LLCs that are actively involved in the business of the partnership or LLC are also self-employed taxpayers subject to the same tax. Limited partners, however, receive special treatment and are allowed to exclude their distributive share of partnership income, except for any guaranteed payments,[4] from their "net earnings from self-employment." LLC members that are not involved in the management of their LLC can claim this same special treatment. S corporation shareholders that work for their corporation, on the other hand, are treated as employees and are not subject to the self-employment tax, but rather, split their employment tax liability with the corporation.

This varied treatment of who is subject to what and in what amounts has allowed taxpayers to take advantage of planning opportunities to avoid employment taxes. Often taxpayers will chose to conduct business through an entity that will allow them to avoid or reduce Federal employment taxes. State law limited partners and LLC members have also relied on the special Federal employment tax treatment created for limited partners to shield amounts from employment tax that are clearly remuneration for services rendered to the partnership or LLC (although not guaranteed payments). The uncertainty inherent in the current Federal employment tax has caused increasing amounts of employment tax avoidance.

On February 26, 2004, Senate Finance Committee Chairman Charles Grassley and Ranking Member Max Baucus wrote a letter to George Yin, Chief of Staff for the Joint Committee on Taxation, requesting the staff of the Joint Committee on Taxation (the "JCT Staff") to prepare periodic reports for Congress that would detail proposals to reduce the estimated $311 billion annual gap between the amount of tax that taxpayers voluntarily and timely pay and the amount of tax that taxpayers should pay if they were to comply with current Federal tax law.[5] The Senators asked that these reports "include proposals to curtail tax shelters, close unintended loopholes, and address other areas of noncompliance in present law."[6]

On January 27, 2005, the JCT Staff presented to Congress its report, entitled *Options to Improve Tax Compliance and Reform Tax Expenditures*. The report includes several proposals that target the noncompliance of self-employed persons to adhere to Federal tax law, which, according to the National Taxpayer Advocate, accounts for the largest share of the known tax gap.[7] One important proposal calls for the modification of the determination of amounts subject to employment or self-employment tax for partners and S corporation shareholders. The JCT Staff estimates that executing the Proposal by modifying Federal tax law will generate nearly $60 billion through 2014.[8]

The JCT Staff's Proposal to Congress advises Congress to restructure the Federal employment tax to impose the self-employment tax on the distributive share of all partners, LLC members and shareholders of S corporations. This Proposal would maintain specific exceptions as provided under present law, which specifies types of income or loss that would be excluded from "net earnings from self-employment" (to which the self-employment tax is imposed), such as certain rental income, dividends and interest, certain gains, and other items. However, all of a taxpayer's net income from a service partnership or service S corporation would be subject to self-employment tax. Under the Proposal, if a partner, LLC member or S corporation shareholder does not materially participate in the trade or business of the partnership, LLC or S corporation, then only the partner's, member's or shareholder's reasonable compensation from the pass-through entity would be treated as net earnings from self-employment and subject to the self-employment tax.

This article will briefly explore current Federal employment tax law, discuss the abuses that have spawned the Proposal, and then detail the provisions of the Proposal itself—including the Proposal's intended results.

The SECA and FICA taxes

Chapters 2 and 21 of the Code impose employment taxes to finance the nation's Social Security and Medicare Benefits. Under Chapter 2, the Self-Employment Contributions Act (the "SECA tax") imposes a tax on an individual's "net earnings from self-employment."[9] In general, net earnings from self-employment is the gross income derived by an individual from any trade or business carried on by the individual, less allowable deductions that are attributable to the trade or business.[10] Specified types of income or loss are specifically excluded from net earnings from self-employment including rentals from real and personal property, interest and dividends, and gains or loss from the sale or exchange of a capital assets or other property that is neither inventory nor held primarily for sale to customers.[11]

The SECA tax has two components, the old-age, survivors, and disability insurance ("OADSI") component and the hospital insurance ("HI") component. Under the OADSI component, the rate of tax is 12.40 percent and the amount of wages subject to this tax is capped at $90,000 for 2005. The HI component is 2.90 percent, and the amount of wages subject to this component is not capped. A self-employed taxpayer is responsible for payment of the entire OADSI tax and HI tax under SECA and receives a deduction for one-half of the tax on his personal income tax return.

Chapter 21 of the Code, entitled the Federal Insurance Contributions Act (the "FICA tax"), imposes a tax similar to the SECA tax on the wages an individual receives as an employee. The FICA tax is also made up of the OADSI and HI components, and the rates under FICA are the same as under SECA. However, while under SECA the self-employed individual is responsible for the entire burden of the employment tax, under FICA the employee splits the tax burden equally with his employer.

The portion of the JCT Staff Proposal that modifies the Federal employment tax treatment of partners, LLC members and S corporation shareholders focuses exclusively on an alteration of the SECA tax. The Proposal broadens the application of the SECA tax for partners and LLC members and imposes the SECA tax on S corporation shareholders who work as employees of the S corporation.

Current Federal Tax Law under the SECA Tax

As stated above, those individuals subject to the self-employment tax under SECA include not only sole proprietors, but also partners (and members of an LLC that is treated as a partnership for Federal tax purposes). The self-employment tax is imposed on a taxpayer's "net earnings from self-employment." In the case of a partner or LLC member, "net earnings from self-employment" include the partner's or member's distributive share (whether or not distributed) of partnership or LLC income.

Code Section 1402(a)(13) provides a special exception in the case of individuals that are limited partners under State law. The exception provides that in determining "net earnings from self-employment," the distributive share of a limited partner is not included in the calculation, except to the extent the distributive share includes guaranteed payments paid as remuneration for the limited partner's service to or for the benefit of the partnership. The Proposal points out that the "special rule reflects State law at the time it was enacted in 1977, under which limited partners ordinarily were not permitted to participate in management of the partnership's activities without losing their limited liability protection."[12]

However, State law has been changing in recent years, with the effect that limited partners are allowed to participate to a greater extent in the management and operations of the limited partnership without losing their limited liability protection. For example, the Texas Revised Limited Partnership Act (the "Texas Act") provides that if a "limited partner does participate in the control of the business, the limited partner is liable only to persons who transact business with the limited partnership reasonably believing, based on the limited partner's conduct, that the limited partner is a general partner."[13] For purpose of the Texas Act, a limited partner may be an employee of the partnership and not be considered to "control" the limited partnership.[14] The Delaware Revised Uniform Limited Partnership Act (the "Delaware Act") allows a limited partner a further departure from the limited partner's traditional role in the business. The Delaware Act provides that a "limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for an obligation of the limited partnership simply by reason of being a limited partner, even if the limited partner participates in the management and control of the limited partnership."[15] This expansion of State law rules for limited partners has paralleled the expanded use of the LLC.[16]

Perceived Failure of the Current Federal Employment Tax Laws

All 50 states have adopted laws that allow for the creation of LLCs. Generally, under State law, members of an LLC can participate in the management and operations of the business without becoming personally liable for the debts and obligations of the business. Under Federal tax law, an LLC can choose to be treated as a corporation or as a partnership (or the LLC can chose to be disregarded if it has a single member owner).[17] If treated as a partnership for Federal tax purposes, the members of the LLC are treated as partners. Under State law, however, LLC members are defined as neither general partners nor limited partners. This has caused many LLC members to characterize themselves as limited partners for Federal tax purposes so as to take advantage of the favorable employment tax treatment afforded limited partners under Code Section 1402(a)(13).

To combat both the aggressive characterization taken by many LLC members and the gradual change in the role of limited partners, the Treasury Department and the Internal Revenue Service (the "Service") issued Proposed Treasury Regulations in 1997 (the "1997 Proposed Regulations") that modify the definition of the term "limited partner" for self-employment tax purposes to not rely on whether the individual is denominated as a limited partner under State law.[18] The 1997 Proposed Regulations state, in part, that:

> Solely for purposes of Section 1402(a)(13) . . . , an individual is considered to be a limited partner . . . *unless* the individual (i) [h]as personal liability . . . for the debts of or claims against the partnership by reason of being a partner; (ii) [h]as authority (under the law of the jurisdiction in which the partnership is formed) to contract on behalf of the partnership; or (iii) [p]articipates in the partnership's trade or business for more than 500 hours during the partnership's taxable year.[19]

The 1997 Proposed Regulations then detail the employment tax treatment for a taxpayer that is deemed, under the Proposed Treasury Regulations, to *not* be a limited partner for Code Section 1402(a)(13) purposes. Under the Proposed Treasury Regulations, a taxpayer that participates in the trade or business of the partnership may bifurcate his distributive share between separate "classes of interest."[20] If the taxpayer holds an interest in the partnership that is identical to the interest held by those partners that qualify as limited partners under the 1997 Proposed Regulations, the taxpayer can exclude the portion of the distributive share allocated to that interest when calculating net earnings form self-employment.[21] The IRS believes these rules will exclude from an individual's net earnings from self-employment amounts that are demonstrably returns on capital invested in the partnership.[22]

The 1997 Proposed Regulations have become highly controversial because many taxpayers believe the Treasury Department and the Service exceeded their authority in providing a definition of the term "limited partner" that could in some cases exclude from limited partner status persons who are denominated as limited partners under State law. In response to these complaints, Congress imposed a moratorium until July 1, 1998, on the issuance of Temporary or Final Treasury Regulations with respect to the definition of a limited partner for self-employment tax purposes (the 1997 TRA).[23]

Under the Senate-passed version of the 1997 TRA, the Senate stated:

> [it] is concerned that the proposed change in the treatment of individuals who are limited partners under applicable State law exceeds the regulatory authority of the Treasury Department and would effectively change the law administratively without congressional action; and the proposed regulations address and raise significant policy issues and the proposed definition of a limited partner may have a substantial impact on the tax liability of certain individuals . . . .[24]

The Senate then declared:

> (1) the Department of the Treasury and the Internal Revenue Service should withdraw Proposed Regulation Section 1.1402(a)-2, which imposes a tax on limited partners; and (2) Congress, not the Department of the Treasury or the Internal Revenue Service, should determine the tax law governing self-employment income for limited partners.[25]

The July 1, 1998, moratorium has expired, but Congress has not enacted legislation concerning the issue. The Service has also not withdrawn the 1997 Proposed Regulations. Theoretically, the Service could finalize the 1997 Proposed Regulations, but such action is unlikely given the concerns expressed by Congress.

Due to Congress' vocal dissatisfaction of the 1997 Proposed Regulations, the uncertainty surrounding the proper treatment of LLC members for Federal tax purposes has become even more pronounced. State law limited partners are able to use the argument that Code Section 1402(a)(13) allows them to participate in the management and operations of their limited partnerships without having to include their distributive shares (except for guaranteed payments) in their "net earnings from self-employment." No similar provision exists for LLC members—causing the 1997 Proposed Regulations to be the best authority on the proper employment tax treatment for LLC members. However, many LLC members rely on the belief that their interest in the LLC is sufficiently analogous to that that of a limited partner's interest to merit special treatment under Code Section 1402(a)(13). The Proposal states that this "uncertainty in treatment [has created] an opportunity for abuse by taxpayers willing to make the argument that they are not subject to any employment tax (FICA or self-employment), even though this argument is contrary to the spirit and intent of the employment tax rules. In addition, the increasing ability of individuals who are limited partners under State law to perform services for the partnership suggests that the limited partner rule is out of date and should be changed."[26]

The Proposal also highlights that the breakdown in Federal employment tax law is not only due to the avoidance of the SECA tax by limited partners and LLC members. It has also become common practice for individuals to set up S corporations to conduct business operations so as to minimize FICA taxes. The S corporation shareholders are able to act as employees of the S corporation; and, as employees, the shareholder-employees are treated like other employees—subjecting them to the FICA tax, and not the SECA tax. The shareholder-employees are responsible for one-half of the tax and the S corporation is responsible for the other half, but in an effort to reduce the amount of total FICA taxes, the shareholder-employees often set their wages at a minimal amount, with the remainder of the S corporation earnings flowing through to them as dividends in their capacity as shareholders. Since dividends are not wages to which FICA is imposed and are excluded from "net earnings from self-employment," the shareholder-employees are able to avoid the SECA tax and minimize their FICA tax liability. The Proposal highlights that while present Federal tax law provides that the entire amount of an S corporation shareholder's "reasonable compensation" is subject to FICA tax, "enforcement of the this rule by the government is difficult because it involves factual determinations on a case-by case basis."[27] This employment tax planning opportunity inherent in S corporations often motivates taxpayers' to choose the S corporation business form based on a desire to avoid or reduce employment taxes rather than by non-tax business considerations.

The JCT Staff Proposal

The JCT Staff Proposal drastically modifies the employment tax for partners, LLC members and S corporation shareholders. Under the Proposal, the present-law Federal employment tax rule for general partners would generally apply to all owners of a partnership, LLC or S corporation. The Proposal would cause all individuals that are characterized as partners for Federal tax purposes to include their distributive share (whether or not distributed) in net earnings from self-employment. In other words, regardless of whether a taxpayer is a State law general partner, limited partner or neither, such as an LLC member, the taxpayer must include his entire distributive share in net earnings from self-employment, the base on which the self-employment tax is levied. No special exception would exist for limited partners to exclude their distributive share from net earnings from self-employment. The Proposal, as under current law, would maintain the exclusion from net earnings from self-employment specified types of income or loss, such as rentals from real and personal property, interest and dividends, and gains or loss from the sale or exchange of a capital assets or other property that is neither inventory nor held primarily for sale to customers. However, the Proposal would modify this exclusion in the case of a service partnership or service LLC. All of a partner's net income from a service partnership, including rentals, interest, dividends and certain gains, would be treated as net earnings from self-employment. The Proposal borrows language from Code Section 448(d)(2) in defining a "service partnership" as a partnership that substantially all of its activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

The Proposal also provides that if a partner or LLC member does not materially participate in the trade or business of the partnership, then only the partner's "reasonable compensation" from the partnership would be treated as net earnings from self-employment. The Proposal describes that "material participation" is a standard that has been frequently applied since its enactment in 1986 as a component of the passive loss rules of Code Section 469,[28] and while the "material participation" standard does require a factual inquiry, the Proposal points out that the standard has been well developed in the Code Section 469 Treasury Regulations.[29] What constitutes "reasonable income" is also a factual inquiry, but the Proposal explains that many judicial decisions have provided guidance on what constitutes "reasonable compensation" by using either a multi-factor test or an independent investor test.[30] The Proposal notes that the "reasonable compensation" determination lacks the predictability that is desirable in a legislative proposal, but that the Proposal looks to reasonable compensation to determine net earnings from self-employment only if the taxpayer does not materially participate in the trade or business, thereby limiting the situations in which this standard applies under the Proposal.[31]

In some cases, the Proposal suggests, a general partner's employment tax liability would actually decrease if the general partner did not materially participate in the partnership's business because only the general partner's reasonable compensation, which may be a very low amount, would be subject to SECA tax instead of the general partner's entire distributive share as provided for under current law. In substance, the Proposal would cause all partners and LLC members to pay self-employment tax on their distributive shares and would shift the burden to the taxpayer to show that the taxpayer does not materially participate in the partnership or LLC and should only be subject to self-employment tax on the partner's reasonable compensation.[32]

To minimize present-law opportunities to avoid the employment tax by recharacterizing wages as some other type of S corporation distribution and to achieve parity between partnerships and S corporations for employment tax purposes, the Proposal would cause an S corporation to be treated as a partnership and S corporation shareholders to be treated as partners for purposes of the employment tax.[33] Thus, instead of S corporation shareholder-employees being subject to FICA on their compensation as employees, the shareholders would be subject to self-employment tax on their distributive entire share of the S corporation's net income. The same rules that would apply to partnerships and LLCs under the Proposal would apply to S corporations. Therefore, certain specified types of income would be excluded from an S corporation shareholder's net earnings from self-employment, such as certain rental income, dividends and interest, certain gains, and other items, unless the S corporation were a service corporation, in which case all of the shareholder's net income from the S corporation would be included in his distributive share and, therefore, in his net earnings from self-employment. Furthermore, under the Proposal, if a shareholder does not materially participate in the trade or business activity of the S corporation, a special rule would provide that only the S corporation's "reasonable compensation" to the shareholder would be treated as net earnings from self-employment.[34] The Proposal explains that the above described modification of the employment tax to S corporation shareholders would improve neutrality of the Federal tax law because the employment tax rules would no longer skew taxpayers' choice of business entity based on the differing FICA and SECA tax results.[35]

Conclusion

The January 27, 2005, JCT Staff report to Congress, *Options to Improve Tax Compliance and Reform Tax Expenditures*, gives some indication of where Congress may focus its tax reform efforts in a move to generate quick revenues and narrow the purported $311 billion annual tax gap. The Proposal, outlined above, self-describes its effect as causing general partners, limited partners, LLC members and S corporation shareholders to be treated similarly to sole proprietors, as well as similarly to each other. The Proposal explains that its conceptual premise rests on the notion that the "base for employment and self-employment tax should be labor income" and that the Proposal applies "this notion more uniformly than does present law to individuals who perform services for or on behalf of a pass-through entity in which they own an interest."[36] The Proposal does vastly more than that attempted by the 1997 Proposed Regulations. The Proposal attempts theoretical consistency of the employment tax rules across entity types by subjecting all income derived from labor to Federal employment tax and by shifting the burden to the taxpayer to show that amounts received from a pass-through entity should not be included in the taxpayer's distributive share due to the taxpayer's lack of material participation in the business of the entity. The Proposal would remove the special exception contained in Code Section 1402(a)(13) for limited partners and would attempt to realign the SECA tax with the modern day role of limited partners and LLC members in the operations and management of the partnership or LLC. The Proposal indicates the modification of the determination of amounts subject to employment or self-employment tax for partners, LLC members and S corporation shareholders would cause a $4.5 billion revenue increase by the end of 2006 and nearly a $60 billion revenue increase by the end of 2014.[37] This revenue, earmarked for Social Security and Medicare, is very attractive in light of the current Social Security reform debates. Whether the Proposal will entice Congress to take action will remain to be seen. In the meantime, tax practitioners will likely need to apprise clients when discussing choice of entity and employment tax matters that the Proposal is in Congress' hands.

ENDNOTES

1 Michael W. Barton is an associate with the law firm of Locke, Liddell & Sapp, LLP, in Houston, Texas.

2 The Proposal is part of the much lengthier report prepared by the Staff of the Joint Committee on Taxation entitled *Options to Improve Tax Compliance and Reform Tax Expenditures*, accessible from http://www.house.gov/jct/s-2-05.pdf (January 27, 2005).

3 Self-employed taxpayers are allowed, however, to deduct one-half of their employment tax liability as a deduction against total income on the front page of their Form 1040. See Code Sections 164(f) and 1402(a)(12).

4 See Code Sections 1402(a)(13) and 707(c).

5 *Proposal* at 3. The letter to Mr. Yin explains that the $311 billion tax gap is an estimate provided by the National Taxpayer Advocate's 2003 Annual Report to Congress for the year 2001.

6 *Id.*

7 National Taxpayer Advocate, *2003 Annual Report to Congress*, Publication 2104 (Rev. 12-2003), at iv.

8 *Proposal* at 425.

9 Code Section 1402(a).

10 *Id.*

11 *Id.*

12 *Social Security Amendments of 1977* (Publ. L. No. 95-216). See also Proposal at 97.

13 *Texas Revised Limited Partnership Act* (2004), Section 3.03(a).

14 *Id.* at Section 3.03(b).

15 *Delaware Revised Uniform Limited Partnership Act* (2001), Section 303.

16 *Proposal* at 98.

17 Code Section 7701(a) and Treas. Reg. Section 301.7701-1, 2 & 3.

18 Prop. Treas. Reg. Section 1.1402(a)-2(h).

19 *Id*. (Emphasis added).

20 Prop. Treas. Reg. Section 1.1402(a)-2(h)(6)(i).

21 Prop. Treas. Reg. Section 1.1402(a)-2(h)(3).

22 *See* Preamble to REG-209824-96, 62 Fed. Reg. 1702 (1/13/1997).

23 *Taxpayer Relief Act of 1997* (Publ. L No. 105-34), Section 935, 105th Cong, 1st Sess, approved Aug. 5, 1997.

24 HR 2014 (Senate Amendment), 105th Cong. 1st Sess. Section 734 (June 27, 1997).

25 *Id*.

26 *Proposal* at 98-99.

27 *Id*. at 99.

28 *Id*. at 102.

29 *Id*.

30 *Id*.

31 *Id*.

32 If the taxpayer does not participate in the partnership or LLC at all, "reasonable compensation" could apparently be set at zero. Otherwise, "reasonable compensation" would likely be imputed if none were paid.

33 *Proposal* at 100 and 103.

34 *Id*. at 100.

35 *Id*. at 103.

36 *Id*. at 101.

37 *Id*. at 425.

FINAL REGULATIONS REGARDING DISREGARDED ENTITIES RELEASED

by Jeff S. Dinerstein[1]

On February 24, 2005, the Internal Revenue Service released final Treasury Regulations regarding the treatment of qualified real estate investment trust subsidiaries ("REIT Subsidiary"), qualified subchapter S subsidiaries ("QSSS"), and single-owner eligible entities ("Single Owner Entities") that are characterized as disregarded, and not as separate from their owner ("Disregarded Entity"). No public comments were received in response to the proposed rulemaking and no public hearing was held. The final Treasury Regulations mirror the proposed rules, with minor changes.

If a Single Owner Entity is treated as a Disregarded Entity, "its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner." Treas. Reg. § 301.7701-2(a). These new regulations define the situations in which Single Owner Entities which are Disregarded Entities are treated as a separate corporation (i.e., not ignored for federal income tax purposes). A Single Owner Entity which is a Disregarded Entity is treated as a separate corporation (i) for periods when the Single Owner Entity was treated as a separate corporation (i.e., periods when the Single Owner Entity was not a Disregarded Entity), (ii) when the Single Owner Entity was liable for the federal tax liabilities of any other entity (e.g., an entity merged into the Single Owner Entity), and (iii) when the Single Owner Entity was eligible for refunds or credits of federal tax. *See amendments to Treas. Reg. § 301.7701-2.*

Furthermore, a REIT Subsidiary and a QSSS are eligible to be treated as Disregarded Entities. The new regulations define specific situations in which a REIT Subsidiary and a QSSS are treated as separate corporations. These situations mirror the three situations outlined above. *See amendments to Treas. Reg. §§ 1.856-9 and 1.1361-4.*

The final Treasury Regulations also provide concrete examples applying these rules. These examples demonstrate that a Disregarded Entity is the proper entity to sign a consent to extend the period of limitations for a period when the Disregarded Entity is treated as a separate corporation under the new rules (e.g., when the entity was not eligible for disregarded entity treatment or when the entity is liable for the debts of another entity because of a merger). The examples also demonstrate that a Disregarded Entity will be treated as a separate corporation in a situation where it is determined that the Disregarded Entity had a deficiency in its taxes while it was a separate corporation (and therefore, a tax lien can be filed against the Disregarded Entity).

These final Treasury Regulations are applicable retroactively. The final Treasury Regulations regarding REIT Subsidiaries and QSSS are effective April 1, 2004. The final Treasury Regulations regarding Single Owner Entities are generally effective on January 1, 1997 (specific sections of the final Treasury Regulations as they apply to Single Owner Entities are effective on various later dates).

ENDNOTE

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MEDIATING APPEALS DISPUTES BETWEEN TAXPAYERS & THE I.R.S.

(5 U.S.C. §§ 571 *et seq*. & Revenue Procedure 2002-44)

by Rod Borlase[1]

In 1990, Congress enacted the *Administrative Dispute Resolution Act (ADRA)*,[2] amended and generally broadened and enhanced in 1996 by *Public Law 104-320*[3] and codified at 5 U.S.C. §§ 571 *et seq*., administratively inaugurated by President Bush the Elder[4] and strengthened and expanded by President Clinton.[5] With that, alternative dispute resolution (*ADR*) became available for most disputes with government agencies, including defense and other government contracts, and certain tax controversies.

Many CPAs and enrolled agents, as well as tax and other attorneys are unaware that taxpayers may now *mediate* certain disputes with the Internal Revenue Service (*IRS*). The ADRA's implementation into IRS Appeals procedures is set forth in IRS Revenue Procedure 2002-44,[6] styled *Appeals Mediation Procedure*.[7] It extends earlier trial programs and establishes mediation as a permanent IRS Appeals procedure, superseding Announcements 98-99 (1998-2 C.B. 650) and 2001-9 (2001-1 C.B. 357).

This procedure pertains to tax controversies in the IRS's Appeals administrative process and announces significant improvements over earlier trial programs. For instance, mediation is no longer limited to adjustments amounting to $1 million or more,[8] is no longer limited to factual, but may also address legal issues,[9] as well as Industry Specialization Program (*ISP*) and Appeals Coordinated Issues (*ACI*)[10] and, if appropriate steps are followed, may be requested even when taxpayers also intend to seek Competent Authority Assistance (*CAA*).[11]

This discussion challenges none of these improvements to dispute resolution options or procedures in IRS-taxpayer controversies; however, It does take issue with one provision buried deep within the revenue procedure's list of *Significant Changes*,[12] bearing upon and fixing precisely who may serve as neutral settlement facilitators, *i.e.*, as mediators – change number 12 of 14 changes.

The IRS's *Appeals Mediation Procedure* is very similar to mediation in other contexts as widely practiced in ordinary civil disputes, except as regards *<u>mediator neutrality</u>*. Consequently, only about five, fewer than ten, IRS-taxpayer mediations per year have occurred nationwide since the ADRA's enactment early in the 1990s. One now-permanent provision undermines this revenue procedure's more frequent use in tax disputes, namely, the requirement that IRS personnel serve as co-mediators. IRS spokespersons defend it, noting that IRS personnel can be, and are instructed to be, as *impartial* as independent (non-IRS-employed) mediators, and further that, of 16 mediations facilitated by IRS personnel alone, 14 settled in mediation, even though it cannot be determined whether that settlement rate (87.5%) is attributable to mediators' fundamental fairness, taxpayers' frustration or financial exhaustion, or to something else.

Given the training and administrative costs to implement and sustain this IRS mediation option, however, there is some question whether that level of use justifies it. Litigants are wary people, often with a great deal at stake, and they want level playing fields and demand unquestionably impartial mediators. They rarely disclose strategic or sensitive information to adversaries' associates, despite mediation privilege and confidentiality rules, and the IRS is no different. IRS-taxpayer mediations would increase substantially, I believe, by removing this requirement from the existing revenue procedure and benefit both the IRS and taxpayers.

With the ADRA, Congress sought to create a less costly, more efficient dispute resolution option and to obtain other benefits ADR promises and richly delivers in ordinary civil litigation. To enable this option, Congress provided, *Any agency may enter into a contract with any person for services as a neutral* ..., 5 U.S.C. § 573(e) and further, *There are authorized to be appropriated such sums as may be necessary to carry out the purposes of this subchapter*. 5 U.S.C. § 584. Given Congress' express intent to (1) *encourage and facilitate agency use of alternative means of dispute resolution* and to (2) *develop procedures that permit agencies to obtain the services of neutrals on an expedited basis*, would Congress likely object, were the IRS to remove this agency-prescribed limitation? 5 U.S.C. § 573(c)(1) and (2) respectively.

Specifically, the Service's administrative implementation of the ADRA statute states, *This mediation procedure requires the use of an Appeals employee who is a trained mediator*, Revenue Procedure 2002-44, § 5.06 (para. 2)[13] meaning an IRS Appeals employee must *<u>always</u>* be either the sole or a co-mediator, whether or not taxpayers choose to hire *independent* or *non-IRS-employed* co-mediators. Taxpayers may proceed with only IRS employees as mediators, thereby avoiding further expense; or, Taxpayers may hire independent co-mediators at their own expense. Few taxpayer-adversaries will respond favorably to this preemptive maneuver, effected at the rules' formation even before the game's start. This bracing predicament is this revenue procedure's nullifying feature.

Interestingly, the revenue procedure expressly acknowledges IRS mediators' conflicts, *Due to the inherent conflict that results because the Appeals mediator is an employee of the IRS*, ... Revenue Procedure 2002-44, § 5.07 (para. 2), necessitating taxpayers' waivers of conflicts as condition precedent to mediations. In civil practice, conflicts are often waived, but not conflicts of this type or magnitude. Few complainants would agree, for instance, to mediate automobile dealership disputes where company policy requires, *The mediator shall be a mediation-trained company employee in the same county, but not the same dealership, where the dispute arises*. That is essentially this revenue procedure's deal.

IRS spokespersons explain, the IRS occupies a special place among government agencies, with special rules and conditions that exist perhaps nowhere else in our governmental system, suggesting in the absence of more specific explanation that special tax expertise is necessary on mediators' parts. Tax expertise, however, is already richly available in properly planned tax mediations, specifically *Counsel for the Taxpayer* and *Counsel for the IRS*; moreover, Nothing restricts mediation sides to the Lone Ranger and, indeed, it is common in mediation for multiple attorneys, advisors or experts to attend for either side or to be otherwise in communication, although only one usually, lead counsel or his client personally, is vested with the final word for each side, *i.e.*, with the *authority to settle*.

Mediators are not arbitrators and are prohibited from acting like judges or jurors; They may neither *rule on matters of law* nor *find facts*, nor enjoy coercive authority while facilitating settlement negotiations. Mediators serve more like diplomats with special portfolio and with special facilitative skills, and *facilitative skill* is precisely what is needed to unravel Gordian knots with antagonists' active collaboration, regardless of whether they are tax or other civil disputes. Mediators' most important, indeed bedrock important traits are *neutrality, confidentiality*, and exceptional ability to interact effectively with different temperaments who strongly embrace conflicting points of view.

Finally, IRS spokespersons point out, Congress was already aware of this procedural requirement in IRS trial programs as the statute and regulations evolved and found no reason to change it, almost as if the IRS has no role in tax-relevant bills' articulation. For the IRS, that is pretty much the end of discussion, *Congress writes the law, and we implement it*. To the suggestion, Congress may have left the gap, but did not mandate this rule, the reply is, *It's policy*, like *It's gravity*. *You can't change gravity*! The question remains, however, whether Congress appreciates the way the IRS construes relevant ADRA provisions.

The ADRA permits, but does not require, use of government-employed mediators in disputes with the government – *A neutral may be a permanent or temporary officer or employee of the Federal Government, or any other individual who is acceptable to the parties* ... 5 U.S.C. § 573(a) – seemingly meaning that trained government mediators are eligible to serve as mediators in disputes with other government agencies when read in conjunction with § 573(d), *An agency may use the services of one or more employees of <u>other agencies</u> to serve as neutrals* ... (Emphasis added by author.) Section 573(d) goes on to authorize interagency agreements for cost reimbursement to those *other agencies*, quite unnecessary when simply borrowing personnel from within one's own agency.

The ADRA's plain reading allows, for example, that mediation-trained Department of the Interior employees might mediate IRS-taxpayer disputes, but not disputes within their own Department as between landowners and the National Park Service, even if their specific jobs were in different Interior bureaus like the Bureau of Indian Affairs, unless of course parties have mutual reasons to choose otherwise. The IRS's interpretation, however, preempts this choice, unilaterally defining, and imposing mediation-trained IRS personnel upon taxpayers, as *tax-mediation-eligible* as from *another agency* even when they work in the same IRS Region,[14] provided they are not from the specific IRS Appeals team handling the controversy. The employment relationship is the problem here – Congress obviously intends that government employees be eligible to serve as mediators, but appears on plain reading to intend it only for services to government agencies other than employees' own.

Moreover, § 573(a) also states, mediators <u>*shall have no official, financial, or personal conflict of interest*</u> *with respect to the issues in controversy, unless such interest is fully disclosed in writing to all parties and all parties agree that the neutral may serve*–emphasis added by author–a construction establishing *no conflicts* as Congress' norm, the dependent clause about *conflict waivers* allowing for occasional exceptions by parties' mutual agreement. The IRS's procedure, however, eliminates the congressional norm altogether and unilaterally establishes *conflict waivers* as the IRS's operational rule. Sections 573(a) and (b) emphasize that neutrals must be acceptable to all parties and serve at the parties' will, thereby forcing relevant discussions under the Service's procedure to choosing which IRS employee is acceptable. As stated, for most civil disputants (including taxpayers), this gambit fosters little trust and few collaborative quests for mutually acceptable solutions, and adversaries' employees become simply unacceptable *ab initio* as neutral intermediaries. Taxpayers' only countervailing option is to forego mediations.

The IRS's interpretation is not entirely unique, the credible legal notion being that, because the statute does not unambiguously prohibit government employees from mediating disputes within their own agencies, it is therefore permitted. Spokespersons in other agencies agree, including agencies that have chosen so far to use non-agency neutrals for their mediations, *e.g.*, the Department of the Interior.[15] This interpretation's unstressed counterpoint, however – and some tax professionals believe it to be the more important to the purpose – is a sort of thumb on the balance favoring the government: 1) weighting any possible mediator influence in the government's favor, and 2) freeing agencies from worries about variable expenditures and independent-mediator contracting hassles, bureaucratic worries.

Perhaps the IRS is mistrusted, even unduly so, as IRS spokespersons claim. Nevertheless, disputing parties demand clearly neutral intermediaries, and this extra IRS requirement does not help. It does not level the playing field so that IRS personnel might serve as mediators, but rather ices it down and prevents players from even assembling; as such, It operates like a stick in the eye or poison pill.

This requirement is unnecessary, improvident, and should be removed. The IRS's Appeals mediation option is a non-starter until this conflict is removed, and the resources spent to maintain it are wasted; or, Have we here an example of an agency, with Congress' avuncular wink, *withholding with one hand what Congress requires the other hand to offer*? The IRS could remove this obstacle on its own, or Congress may need to tweak the ADRA, either cure being better than judicial involvement.

My concern here is a mediator's traditional concern, that is, with surmounting obstacles to reach greater benefits mediation offers both the IRS and taxpayers.

ENDNOTES

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2 *Public Law* 101-552, November 15, 1990, 104 Stat. 2738. [NB: Not to be confused with the A*lternative Dispute Resolution Act of 1998*, added by *Public Law 100-702, Title IX, § 901(a)*, November 19, 1988, 102 Stat. 4659, & amended by *Public Law 105-315, § 3*, October 30, 1998, 112 Stat. 2993, codified at 28 U.S.C. § 651, establishing court-annexed ADR among federal judicial procedures.]

3 October 19, 1996, 110 Stat. 3870; herewith short-titled the *Administrative Dispute Resolution Act of 1996*.

4 *Executive Order 12,778*, 56 FR 55,195, October 23, 1991.

5 *Executive Order 12,988*, 61 FR 4,729, February 5, 1996.

6 *Rev. Proc. 2002-44, 2002-2 C.B. 10, 2002-26 I.R.B. 10*.

7 Released June 7th and published July 1st, 2002.

8 *Rev. Proc. 2002-44, § 3.01*, referencing key changes, jurisdictional limits, qualifying issues, and formally establishing the program.

9 *Rev. Proc. 2002-44, § 3.02*, referencing to *§ 4.02(2)* regarding *eligible mediation issues*.

10 *Rev. Proc. 2002-44, § 3.03*, referencing to *§ 4.02(3)* regarding *ISP* and *ACI* issues.

11 *Rev. Proc. 2002-44, § 3.04*, referencing to *§ 4.02(4)* regarding *CAA* procedures.

12 *Rev. Proc. 2002-44, Section 3. Significant Changes*. – General itemization of *Significant Changes*.

13 Also referenced among *Significant Changes* at Revenue Procedure 2002-44, § 3.12.

14 The traditional organizational designation, *Region*, has recently changed, but the technical point remains the same; Other organizational terminology has recently changed as well.

15 *Department of the Interior Notice, Use of Alternative Dispute Resolution*, 61 FR 40,424, August 2, 1996, RIN 1094-AA-45. [NB: This Notice is currently under review for revision.]

ENHANCED OIL RECOVERY CREDITS

Mary A. McNulty and Janet P. Jardin

This article discusses the federal income tax credits available for enhanced oil recovery ("EOR") projects and the issues presented when EOR projects begun before 1991 are significantly expanded. This article has been prepared by Mary A. McNulty,[1] Chair of the Energy and Natural Resources Committee and a senior partner at Thompson & Knight LLP, and Janet P. Jardin,[2] an associate at Thompson & Knight, as a project of the Energy and Natural Resources Tax Committee. Unless otherwise indicated, all Section references are to the Internal Revenue Code of 1986, as amended (the "Code").

I. Background

A. Overview of EOR Operations

EOR operations are the third stage of hydrocarbon production during which complex techniques are used to alter the properties of oil by restoring formation and improving oil displacement or fluid flow. The three major types of EOR activities are chemical flooding, miscible displacement (CO2 injection), and steamfloods. This article focuses on CO2 injections because they are the most common EOR operations in Texas. Almost all CO2 floods in the United States occur in west Texas because of its proximity to a CO2 source in New Mexico used to flood the deep oil reservoirs.

CO_2 EOR projects involve a miscible gas flood of an oil reservoir, which improves oil recovery as the injected gas becomes miscible (or becomes one liquid phase) with the oil and helps push the oil through the rock reservoirs and to the producing wells. CO_2 is continually added to the oil reservoir by being compressed and pushed in, and when it is produced back out with the enhanced oil that is recovered, it is recaptured and reinjected along with new CO_2, and the cycle begins anew. An industry standard is that an additional 5,000 to 10,000 cubic feet of CO_2 will produce one barrel of oil.

B. Reasons for the EOR Credit

Congress enacted Section 43 of the Code in 1990 to encourage the expansion of U.S. oil production through the use of EOR production methods, which Congress viewed as "essential to national security."[3] Congress sought to encourage the expanded use of EOR methods to increase proven oil reserves in the United States. EOR projects have the potential to recover substantial amounts of oil from known U.S. reserves. But EOR projects were not often put into practice because they require increased production costs for declining well productivity that characterizes mature fields. Economically successful CO_2 EOR projects are difficult to predict because ultimately they are dependent on the uncertainties of the geological make-up of the reservoir and the price of oil. Tax incentives are instrumental in encouraging the expanded use of EOR production methods by offsetting production costs. Congress anticipated that EOR projects would result in more than an additional 20 billion barrels of oil recovered through tertiary methods that would not have been produced absent a tax credit.[4]

II. Overview of the Section 43 EOR Credit

Section 43 allows taxpayers a credit for a portion of their "qualified EOR costs" incurred in connection with a "qualified enhanced oil recovery project."[5] The credit is part of the general business credit and thus subject to the limitations on carryovers that apply to that credit under Sections 38 and 39.

A. Qualified EOR Projects

To be a "qualified enhanced oil recovery project," the following three requirements must be satisfied:

(1) The project must involve the application of a tertiary recovery method that can be reasonably expected to result in more than an insignificant increase in the amount of crude oil that ultimately will be recovered;

(2) The project must be located in the United States; and

(3) The first injection of liquids, gases, or other matter must occur after December 31, 1990, or the project must be significantly expanded after December 31, 1990.

A project is not treated as a qualified EOR project unless the operator submits to the Secretary a certification from a petroleum engineer that the project meets and continues to meet these requirements.[6] This requirement is discussed in Part III below.

The transitional rule for significant expansions mentioned in requirement (3) above, and discussed in Part IV below, is the most controversial aspect of the Section 43 EOR credit.

B. Qualified EOR Costs

The EOR credit base consists of the following types of costs:[7]

(1) Intangible drilling and development costs that are paid or incurred in connection with a qualified EOR project and with respect to which the taxpayer may elect to deduct currently under Section 263(c).

(2) Costs of tangible property that are depreciable or amortizable costs incurred for tangible property that is an integral part of a qualified EOR project.

(3) Tertiary injectant expenses that are paid or incurred in connection with a qualified EOR project and for which is a deduction is allowed.

(4) Costs paid or incurred after 2004 to construct a gas treatment plant located within the United States, north of the 64 degree latitude line, which prepares Alaska natural gas for transportation through a pipeline of capacity at least 2 trillion BTU per day that produces carbon dioxide and injects it into hydrocarbon-bearing geological formations.

To be included in the credit base, the property must be used primarily to implement a qualified EOR project. Generally, property used to acquire or produce the tertiary injectant or transport it to a project qualifies for the credit.[8] Property used in more than one qualified EOR project must be allocated among the various projects. Further, property used partly for another activity must be allocated between the qualifying uses and the nonqualifying uses, unless the nonqualifying uses are de minimis (such as 10% or less).[9]

C. Phase-Out of the EOR Credit

The credit is subject to phase-out for any taxable year in which the reference price of crude oil (determined under Section 29(d)(2)(C)) exceeds $28 (adjusted for inflation). The amount of the credit is reduced by a certain percentage. This percentage is determined by dividing by $6 the amount by which the reference price of oil for the preceding calendar year exceeds $28. Under the statutory formula, the inflation adjustment aside, the credit is wholly phased out if the reference price of oil equals or exceeds $34.[10]

III. The Certification Requirements

Two types of certifications are required under the Section 43 Regulations: initial certifications and continuing certifications. A taxpayer should take care to satisfy all of the requirements. However, because a taxpayer often is not the operator of the project, the information required for the certification may be difficult to obtain. As discussed below, substantial compliance with the certification requirements should be sufficient to qualify for the EOR credit, as long as all the other requirements are met.

A. Initial Certification

Treasury Regulations Section 1.43-3(a) requires certification, under penalties of perjury, by a petroleum engineer, duly registered or certified in any state, that a certain project qualifies as an EOR project under Section 43(c)(2)(A).[11] The certification is to be filed by the operator by the due date of the operator's federal income tax return (including extensions) for the first taxable year for which the EOR credit is allowable.[12] The original certification must provide the following information:

(1) A statement that the application of a qualified tertiary recovery method is expected to result in a more than insignificant increase in the amount of crude oil that ultimately will be recovered;

(2) Estimates of crude oil reserves with and without the EOR project;

(3) Production history and estimates of post-EOR production;

(4) An adequate delineation of the reservoir, or portion of the reservoir, from which the ultimate recovery of crude oil is expected to be increased as a result of the implementation and operation of the EOR project; and

(5) For significant expansion projects that affect reservoir volume substantially unaffected by pre-1991 injections, an adequate delineation of the reservoir volume affected by the pre-1991 project.[13]

B. Continuing Certifications

In addition to an original certification, Section 43(c)(2)(B) of the Code requires an operator to certify that the project continues to meet the requirements of a qualified enhanced oil recovery project. Treasury Regulations Section 1.43-3(b)(3) details the specific information that must be included in a continuing certification, as follows:

(1) The name and taxpayer identification number of the operator;

(2) A statement identifying the project, including its geographic location and date on which the original certification was filed;

(3) A statement, signed under penalties of perjury, that the project continues to be implemented substantially in accordance with the original certification submitted for the project; and

(4) A description of any significant change or anticipated change in the information submitted in the original certification.

The certification is to be filed by the operator by the due date of the operator's federal income tax return (including extensions) for that year.[14]

As a best practice, a taxpayer should submit a separate document certifying each EOR project. However, the inclusion of multiple EOR projects in a single document should not disqualify the projects for the tax credit, as long as the document identifies each project to which it applies and the certification contains, for each project, all other information required by Treasury Regulations Section 1.43-3(b).

C. Substantial Compliance

Treasury Regulations Section 1.43-3(d) postpones, rather than denies, the allowance of an EOR credit if a certification is incomplete. This provision allows the EOR credit once the appropriate certifications are submitted:

> If a petroleum engineer's certification (as described in paragraph (a) of this Section) or an operator's certification (as described in paragraph (b) of this Section) is not submitted in the time or manner prescribed by this Section, the credit will be allowed only after the appropriate certifications are submitted.

The certification requirements are not essential to the availability of the EOR credit. Rather, Congress established the certification requirements to facilitate the orderly and prompt determination of whether a project is a qualified EOR project. Thus, Section 43 certification requirements are procedural and directory, and only substantial compliance with them should be required.[15]

The substantial compliance doctrine is especially appropriate in EOR credit cases because the preparation of the certifications is generally left to the operator, not the individual taxpayer. So long as the certifications show that the projects satisfy the Code requirements for the EOR credit, a non-operator should not be penalized if the certifications only substantially comply with all of the technical requirements.

IV. The Transitional Rule for Significant Expansions

A. Overview of the Transitional Rule for Significant Expansions

Under the transitional rule for significant expansions, a pre-1991 EOR project that is significantly expanded after 1990 is treated as a separate project for which the first injection of liquids, gases, or other matter is deemed to occur after 1990.[16] Treasury Regulations Section 1.43-2(d)(2) provides:

> (2) *Substantially unaffected reservoir volume.* A project is considered significantly expanded if the injection of liquids, gases, or other matter after December 31, 1990, is reasonably expected to result in more than an insignificant increase in the amount of crude oil that ultimately will be recovered from reservoir volume that was substantially unaffected by the injection of liquids, gases, or other matter before January 1, 1991.

Thus, under Treasury Regulations Section 1.43-2(d)(2), a project is considered significantly expanded if two tests are satisfied. First, the expected recovery must come from reservoir volume that was "substantially unaffected" by pre-1991 injections. Second, those post-1990 injections must be "reasonably expected" to result in more than an "insignificant increase" in the amount of crude oil that ultimately will be recovered.

B. Substantially Unaffected Reservoir Volume.

Treasury Regulations Section 1.43-2(d)(2) considers a project significantly expanded if it affects *reservoir volume* that was substantially unaffected by a pre-1991 project.[17] Treasury explicitly rejected the acreage or reservoir test of the proposed regulations and adopted the reservoir volume test, explaining that reservoir volume "more realistically reflects the three-dimensional concept petroleum engineers use in measuring reserves and the ultimate recovery of oil in place."[18] Under the acreage test, a lateral expansion would have qualified for the credit, whereas a vertical expansion would not have qualified unless it affected a previously unaffected reservoir. Thus, whether a project is significantly expanded depends on reservoir volume, not acreage or even the reservoir itself.

The terms "reservoir" and "reservoir volume" are distinct. Reservoir is a general term and refers to the entire formation. The reservoir is a porous and permeable lithological unit or set of units that holds the hydrocarbon reserves. By contrast, reservoir volume refers to the content of the reservoir and the amount of oil, water, and gas in the reservoir. The mere injection of solvent into a reservoir does not automatically substantially affect the reservoir volume. Rather, there must also be substantial displacement.

Many reservoirs are composed of layers with varying degrees of permeability. Layers that are more permeable will process injected CO_2 faster than less permeable layers. CO_2 that is injected into a well sweeps across the layers of the reservoir at different rates. More oil from the permeable layers is pushed toward the producing wells. Conversely, the injected CO_2 contacts less oil from the less permeable layers of the reservoir. By increasing the hydrocarbon pore volume target, CO_2 is able to contact the less permeable layers of the reservoir and sweep out more oil therefrom. These less permeable layers contain reservoir volumes that may be substantially unaffected by pre-1991 injections.

Example 1 of the Regulations illustrates the significant expansion exception as follows:

> Example (1). Substantially unaffected reservoir volume. In January 1988, B, the owner of an operating mineral interest in a property, began injecting steam into the reservoir in connection with a cyclic steam enhanced oil recovery project. The project affected only a portion of the reservoir volume. In 1992, B begins cyclic steam injections with respect to reservoir volume that was substantially unaffected by the previous cyclic steam project. Because the injection of steam into the reservoir in 1992 affects reservoir volume that was substantially unaffected by the previous cyclic steam injection, the cyclic steam injection in 1992 is treated as a separate project for which the first injection of liquids, gases, or other matter occurs after December 31, 1990.[19]

Thus, if post-1990 activities affect reservoir volume not substantially affected by pre-1991 activities, the project will be significantly expanded for purposes of the EOR credit.

C. Reasonable Expectation of More Than an Insignificant Increase in Recovery

To satisfy the second prong of the significant expansion rule, a taxpayer must show that post-1991 CO_2 injections are reasonably expected to result in more than an insignificant increase in the amount of oil that ultimately will be recovered from the reservoir volume.[20] The Treasury Regulations require that the taxpayer's expectation as to the increase in production be reasonable. Actual results that are close to the forecasted results should prove the reasonableness of the taxpayer's expectation.

Simply accelerating production from an EOR project after 1990 does not qualify as a significant expansion.[21] As with any EOR project, the taxpayer must show that the application of the tertiary recovery method can be reasonably expected to result in more than an insignificant increase in the amount of crude oil that will ultimately be recovered.[22] Merely accelerating production does not result in an overall increase in the amount of crude oil recovered. Therefore, a project that merely accelerates production is not a qualified EOR project.

D. Post-1990 Change in EOR Methods

Generally, a project affecting a reservoir that was previously affected by a tertiary recovery method nonetheless constitutes a significant expansion if the prior method has been terminated for at least 36 months.[23] If a pre-1991 project has not been terminated for at least 36 months before implementing a post-1990 project, a taxpayer may request a private letter ruling from the IRS as to whether "the application of a different tertiary recovery method or methods after December 31, 1990, that does not affect reservoir volume substantially unaffected by the previous tertiary recovery method or methods, is treated as a significant expansion."[24] Importantly, a taxpayer whose post-1990 activities increase recovery from reservoir volume that was not substantially affected by pre-1991 injections is not eligible to submit a private letter ruling request under Treasury Regulations Section 1.43-2(d)(4).

For purposes of this rule, a more intensive application of a method is not considered a change in recovery method.[25] Example 5 of Treasury Regulations Section 1.43-2(d)(5) illustrates the application of this rule (emphasis added):

> Example (5). More intensive application of a tertiary recovery method. In 1989, F, the owner of an operating mineral interest in a property, undertook an immiscible carbon dioxide displacement enhanced oil recovery project. F began injecting carbon dioxide into the reservoir under immiscible conditions. The injection of carbon dioxide under immiscible conditions resulted in more than an insignificant increase in the ultimate recovery of crude oil from the property. F continues to inject the same amount of carbon dioxide into the reservoir until 1992, when new engineering studies indicate that an increase in the amount of carbon dioxide injected is reasonably expected to result in a more than insignificant increase in the amount of crude oil [that] would be recovered from the property as a result of the previous injection of carbon dioxide. *The increase in the amount of carbon dioxide injected affects the same reservoir volume that was affected by the previous injection of carbon dioxide.* Because the additional carbon dioxide injected in 1992 does not affect reservoir volume that was substantially unaffected by the previous injection of carbon dioxide and the previous immiscible carbon dioxide displacement method was not terminated for more than 36 months before additional carbon dioxide was injected, the increase in the amount of carbon dioxide injected into the reservoir is not a significant expansion. Therefore, it is not a separate project for which the first injection of liquids, gases, or other matter occurs after December 31, 1990.

As the italicized sentence shows, this example assumes that the increased amount of CO_2 that is injected into the reservoir affects the same reservoir volume that was affected by the previous injection of CO_2. Because the project does not affect reservoir volume that was substantially unaffected by the pre-1991 project and the new project was begun within 36 months of when the prior project terminated, the new project did not qualify for the EOR credit.

E. Examples of CO_2 Significant Expansion Projects

Discussed below are three types of EOR projects that may qualify as significant expansions if all the other credit requirements are met.

- *Increase in Slug Size.* An increased slug size normally invades the less porous reservoir rock, loosens and displaces oil from the rock, and pushes it to a producing well. Because of variations in permeability of the subsurface rock and various other geological attributes, there are significant areas of pore volume that are never contacted or displaced by the CO_2 without more injections, without significant engineering work to study the effects of the injection program, and without making improvements as additional knowledge is gained. When the slug size is increased, more CO_2 invades the rock and more oil is displaced and swept to the producing well. A post-1990 increase of the CO_2 slug size should qualify as a significant expansion project under Section 43 if the increased slug size affects reservoir volume that was substantially unaffected by pre-1991 CO_2 injections and increases recovery.

- *Vertical Expansion.* Consistent with the three-dimensional concept of reservoir volume, a vertical expansion should generally qualify as a significant expansion project, so long as the vertical expansion increases recovery from substantially unaffected reservoir volume.

- *Reconfiguration of Injection Pattern.* The purpose of reconfigurations is to contact oil not displaced by previous injections, so that more oil can be removed from the reservoir rock and swept through the reservoir to producing wells. Improving the placement of injector and producing wells may allow CO_2 to invade new reservoir volume, which allows additional oil to be displaced and recovered. Further, infill wells may allow injectants to reach some rock that was not previously touched by the injectants at all. Reconfigurations that affect reservoir volume that was not substantially affected by pre-1991 injections and increase recovery should qualify for the significant expansion exception.

V. Conclusion

When Congress enacted Section 43, it intended to stimulate the investment in EOR projects and significantly increase domestic production. Congress recognized that such investments are expensive and therefore enacted a tax credit to serve as an incentive for making investments in EOR projects. If a taxpayer carefully implements its EOR projects, it can benefit from the EOR credit and make otherwise marginal projects profitable.

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3 *See* Sen. Comm. Rpt. for P.L. 101-508, 101st Cong. (1990).

4 *Id.*

5 I.R.C. § 43(c).

6 I.R.C. §§ 43(c)(2)(A)(i)-(iii), 43(c)(2)(B); Treas. Reg. § 1.43-2(a)&(d).

7 I.R.C. § 43(c).

8 Treas. Reg. § 1.43-4(c)(3).

9 Treas. Reg. §§ 1.43-4(a)(2), -4(c)(2).

10 I.R.C. § 43(b).

11 Treas. Reg. § 1.43-3(a)(1).

12 Treas. Reg. § 1.43-3(a)(2).

13 Treas. Reg. §§ 1.43-3(a)(3)(i)(D), (ii)(A).

14 Treas. Reg. § 1.43-3(a)(2).

15 *See, e.g., Tipps v. Comm'r,* 74 T.C. 458 (1980), *acq.*, 1981-2 C.B. 2; Priv. Ltr. Rul. 200221020 (02/15/2002).

16 P.L. 101-508, § 11511(d)(2); Treas. Reg. § 1.43-2(d)(1).

17 Treas. Reg. § 1.43-2(d)(2).

18 T.D. 8448 (Nov. 23, 1992) (preamble to final Regulations).

19 Treas. Reg. § 1.42-2(d)(5), Ex. (1).

20 Treas. Reg. § 1.43-2(d)(2).

21 *See* Treas. Reg. § 1.43-2(b) (providing that a mere acceleration of recovery is not a significant expansion).

22 I.R.C. § 43(c)(2)(A)(i).

23 Treas. Reg. § 1.43-2(d)(3).

24 Treas. Reg. § 1.43-2(d)(4) (emphasis added).

25 *Id.*

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